

IN THE  
**Supreme Court of the United States**

OCTOBER TERM, 1969

No. 678

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JAMES G. NASH, ET AL

*Petitioners,*

VS.

UNITED STATES

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ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF  
APPEALS FOR THE FIFTH CIRCUIT

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UNITED STATES DISTRICT COURT  
NORTHERN DISTRICT OF ALABAMA

Civil Action 67-247

[Caption Omitted]

DOCKET ENTRIES

<i>Date</i>	<i>Material Filed</i>
April 28, 1967	Complaint Filed.
April 28, 1967	Summons & Complaint issued—delivered to U. S. Marshal for service.
May 3, 1967	Summons & Complaint returned executed on May 3, 1967 and filed.
June 26, 1967	Answer of Defendant filed — copy served by counsel.
January 18, 1968	Order dated January 17, 1968, on pre-trial hearing and consolidating C.A. 67-247, C.A. 67-248 and C.A. 67-249 for trial only and requesting counsel for defendants to file brief or or before April 1, 1968, and Counsel for Plaintiffs may file reply brief on or before May 1, 1968, filed and entered (Lynne)—Copies mailed to attorneys.
April 8, 1968	Stipulation of facts filed.
June 10, 1968	On trial before Hon. Seybourn H. Lynne, without Jury—Parties advised Court they had reached settlement in this action—Findings of Fact, Conclusions of Law and Judgment to be entered.

*Date**Material Filed*

June 12, 1968

Findings of Facts and Conclusions of Law of Hon. Seybourn H. Lynne, C.A. 67-247, C.A. 67-248 and C.A. 67-249, Southern Division, having been consolidated for trial only and submitted for final judgment by the Court, without the intervention of a jury, upon the pleadings, the order on pre-trial hearing, the stipulation of facts entered into by the parties hereto, filed.

June 12, 1968

Judgment in conformity with findings of fact and conclusions of law contemporaneously filed herewith that Plaintiff, Birmingham Trust National Bank, as Trustee under the James G. Nash, Jr. Trust, have and recover of Defendant, United States of America, the sum of \$1,274.98, with interest as allowed by law from November 2, 1965, filed and entered (Lynne)—Copies mailed to attorneys.

June 12, 1968

Judgment in conformity with the findings of fact and conclusions of law contemporaneously filed herewith, that Plaintiffs, James G. Nash and Cecelia Nash, have and recover of Defendant, United States of America, the sum of \$59,256.75, with interest as allowed by law from January 12, 1966, filed and entered (Lynne)—Copies mailed attorneys.

June 12, 1968

Judgment in conformity with the findings of fact and conclusions of law contemporaneously filed herewith, that Plaintiff, Birmingham Trust National Bank, as Trustee of the

*Date**Material Filed*

Margaret Nash Trust, have and recover of Defendant, United States of America, the sum of \$1,273.73, with interest as allowed by law from November 2, 1965, filed and entered (Lynne)—Copies mailed attorneys.

August 12, 1968

Notice of appeal by Defendant filed—cert. copy mailed to Plaintiffs' attorneys.

September 20, 1968

Order on Motion of U. S. Attorney extending time within which record on appeal in this cause shall be filed and docketed in U. S. Court of Appeals for the Fifth Circuit for 50 days from September 21, 1968, filed and entered (Lynne)—Copies mailed to attorneys—Cert. copy mailed to clerk, U. S. Court of Appeals, New Orleans, Louisiana.

UNITED STATES COURT OF APPEALS  
FOR FIFTH CIRCUIT

[Caption Omitted]

RELEVANT DOCKET ENTRIES

<i>Date</i>	<i>Material Filed</i>
November 5, 1968	Docketing Cause, etc.
November 13, 1968	Filing order of District Court extending time for filing the record.
November 13, 1968	Filing record on appeal.
November 25, 1968	Filing stipulation for consolidation of Cases No. 26928, 26929 and 26930.—approved.
December 23, 1968	Filing 10 printed copies of the appendix.
December 23, 1968	Filing of briefs for appellant.
January 23, 1969	Filing of brief for appellee.
March 18, 1969	Assigned for May 2, 1969, at Jacksonville.
May 2, 1969	Argued and submitted before Judges Tuttle, Simpson and Cassibry.
July 2, 1969	Reversed "per Tuttle, C.J."
July 31, 1969	— Judgment as mandate issued to clerk, Birmingham, Alabama, with opinion.

IN THE UNITED STATES DISTRICT COURT FOR  
THE NORTHERN DISTRICT OF ALABAMA,  
SOUTHERN DIVISION

[Caption Omitted]

ORDER ON PRETRIAL HEARING  
(Filed January 18, 1968)

The above cases coming on to be heard on a regular pretrial hearing and all parties being present in person or by counsel, the following action was thereupon taken.

1. The following pleadings and amendments were allowed in each case: The complaint and the answer.

For the convenience of the parties and in the interest of justice, it is ORDERED that these actions be consolidated for purpose of trial only.

2. It was agreed by all of the parties that the following are all of the issues in controversy in these cases:

In No. 67-247 plaintiff claims of defendant a refund of income taxes for the calendar year 1961 in the amount of \$1,273.73, with interest as allowed by law; in 67-248 plaintiff claims of defendant a refund of income taxes for the year 1961 in the amount of \$59,256.75; in 67-249 plaintiff claims of defendant a refund of income taxes for the year 1961 in the amount of \$1,274.98.

In each case it is the contention of plaintiff that the Commissioner erred in including in the gross income of the taxpayer for such year the bad debt reserve set up by the partnership. The partners had organized eight separate corporations to which the assets of the partnership, including accounts receivable and the bad debt reserve, had been transferred in exchange for the stock of each corporation. (This was the practical effect of transferring the accounts receivable at their face value from which was deducted the bad debt reserve.)

Pleading the general issue, defendant contends that when the accounts receivable were transferred to the corporations, the partnership no longer had any need for the bad debt reserve.

It is agreed that the facts are capable of full stipulation. Attorneys for the plaintiff are requested to prepare a suggested stipulation and submit it to counsel for defendant for approval.

Counsel for defendant are requested to file a brief on or before April 1, 1968. Counsel for plaintiffs may file a reply brief on or before May 1, 1968.

It is therefore ORDERED by the court that all of the above-named allowances and agreements be and the same are hereby binding upon all parties in the above cases, unless this order be hereafter modified by order of the court.

Done, this the 17th day of January, 1968.

SEYBOURN H. LYNNE,  
*Chief Judge*

IN THE UNITED STATES DISTRICT COURT FOR  
THE NORTHERN DISTRICT OF ALABAMA,  
SOUTHERN DIVISION

[Caption Omitted]

STIPULATION OF FACTS  
(Filed April 8, 1968)

It is hereby stipulated and agreed by and between the parties to the above cases, for the purpose of the trial of the above entitled and numbered cases, that upon the trial of said actions the following facts are admitted and agreed upon by the parties and shall be taken as true without any evidence being produced thereon. However, other and additional proof as to any fact or matter not consistent with the statements contained in this stipulation may be introduced by either of the parties:

1. James G. Nash, Birmingham Trust National Bank, as Trustee under the James G. Nash, Jr., Trust, and Birmingham Trust National Bank, as Trustee under the Margaret Nash Trust, were, during the calendar year 1961, partners in a partnership operating various finance businesses.

2. The partnership operated ten (10) distinct finance operations, eight (8) were conducted in Birmingham and Tuscaloosa, Alabama, and two (2) were conducted in Columbia and Greenville, South Carolina.

3. The partnership had as its taxable year the fiscal year ending January 31.

4. The partnership used the accrual method of accounting for reporting its income, and the reserve method of accounting for bad debts.

5. On June 1, 1960, the eight (8) Alabama finance companies were incorporated into eight (8) separate corporations organized under the laws of the State of Alabama.

6. As of May 31, 1960, the partnership books reflected accounts receivable in the Alabama operations in the face amount of Four Hundred Eighty-six Thousand Eight Hundred Fifty-three and 69/100 Dollars (\$486,853.69) and a reserve for bad debts applicable thereto in the amount of Seventy-three Thousand Twenty-eight and 05/100 Dollars (\$73,028.05).

7. On June 1, 1960, the partnership transferred to the eight corporations, in compliance with Section 351 of the Internal Revenue Code of 1954, as amended, the following assets and liabilities solely in exchange for the stock and securities shown below:

(A) *Sun Finance Company of Tuscaloosa, Inc.*

Cash		\$ 1,411.03
Accounts Receivable	\$53,859.27	
Less: Reserve for bad debts	8,078.89	
		45,780.38
Furniture & Fixtures	3,458.73	
Less: Reserve for Accumulated Depreciation	3,157.94	
		300.79
<b>TOTAL ASSETS</b>		<b>\$47,492.20</b>
Liabilities		11,449.55
Paid-in Surplus		1,042.65
Stock and Securities		35,000.00
<b>TOTAL LIABILITIES &amp; CAPITAL</b>		<b>\$47,492.20</b>

(B) *Nash Finance Company of Birmingham, Inc.*

Cash .....	\$14,006.57	
Accounts Receivable .....	\$85,847.52	
Less: Reserve for bad debts ..	<u>10,852.46</u>	
		74,995.06
Furniture & Fixtures .....	\$23,862.77	
Less: Accumulated		
Depreciation .....	<u>18,956.93</u>	
		4,905.84
TOTAL ASSETS .....		\$93,907.47
Liabilities .....		16,050.85
Paid-in Surplus .....		856.62
Stocks and Securities .....		<u>77,000.00</u>
TOTAL LIABILITIES & CAPITAL ..		\$93,907.47

(C) *Sun Finance Company of Birmingham, Inc.*

Cash .....	\$ 1,615.44	
Accounts Receivable .....	\$46,885.35	
Less: Reserve for bad debts ..	<u>7,032.80</u>	
		39,852.55
Furniture & Fixtures .....	4,150.41	
Less: Accumulated		
Depreciation .....	<u>3,038.81</u>	
		1,111.60
TOTAL ASSETS .....		\$42,579.59
Liabilities .....		9,952.51
Paid-in Surplus .....		627.08
Stocks and Securities .....		<u>32,000.00</u>
TOTAL LIABILITIES & CAPITAL ..		\$42,579.59

(D) *Nash Finance Company of Tuscaloosa, Inc.*

Cash .....	\$ 2,363.58	
Accounts Receivable .....	\$69,976.11	
Less: Reserve for bad debts ..	<u>10,496.42</u>	
		59,479.69

Furniture & Fixtures	3,861.57	
Less: Accumulated Depreciation	<u>3,611.89</u>	249.68
TOTAL ASSETS		<u>\$62,092.95</u>

Liabilities	14,802.31	
Paid-in Surplus	290.64	
Stocks and Securities	<u>47,000.00</u>	
TOTAL LIABILITIES & CAPITAL		<u>\$62,092.95</u>

(E) *Key Finance Company of Birmingham, Inc.*

Cash		\$ 1,351.06
Accounts Receivable	\$62,769.55	
Less: Reserve for bad debts	<u>9,341.93</u>	53,427.62

Furniture & Fixtures	3,596.78	
Less: Accumulated Depreciation	<u>1,643.92</u>	1,952.86
TOTAL ASSETS		<u>\$56,731.54</u>

Liabilities	13,057.40	
Paid-in Surplus	674.14	
Stocks and Securities	<u>43,000.00</u>	
TOTAL LIABILITIES & CAPITAL		<u>\$56,731.54</u>

(F) *Gray Finance Company of Birmingham, Inc.*

Cash		\$ 2,487.61
Accounts Receivable	\$49,989.50	
Less: Reserve for bad debts	<u>7,498.42</u>	42,491.08

Furniture & Fixtures	5,225.43	
Less: Accumulated Depreciation	<u>4,655.09</u>	570.34
TOTAL ASSETS		<u>\$45,549.03</u>

Liabilities	10,635.08	
Paid-in Surplus	913.95	
Stocks and Securities	<u>34,000.00</u>	
TOTAL LIABILITIES & CAPITAL		<u>\$45,549.03</u>

(G) *Delta Finance Company of Tuscaloosa, Inc.*

Cash .....	\$ 1,647.23
Accounts Receivable .....	\$58,187.24
Less: Reserve for bad debts .....	8,728.09
	49,459.15
Furniture & Fixtures .....	2,578.21
Less: Accumulated Depreciation .....	1,765.24
	812.97
<b>TOTAL ASSETS .....</b>	<b>\$51,919.35</b>
Liabilities .....	12,314.18
Paid-in Surplus .....	605.17
Stocks and Securities .....	39,000.00
<b>TOTAL LIABILITIES &amp; CAPITAL .....</b>	<b>\$51,919.35</b>

(H) *Delta Finance Company of Birmingham, Inc.*

Cash .....	\$ 1,226.82
Accounts Receivable .....	\$73,326.93
Less: Reserve for bad debts .....	10,999.04
	62,327.89
Furniture & Fixtures .....	4,671.53
Less: Accumulated Depreciation .....	3,044.80
	1,626.73
<b>TOTAL ASSETS .....</b>	<b>\$65,181.44</b>
Liabilities .....	15,513.84
Paid-in Surplus .....	667.60
Stocks and Securities .....	49,000.00
<b>TOTAL LIABILITIES &amp; CAPITAL .....</b>	<b>\$65,181.44</b>

8. After their incorporation, the eight corporations continued to conduct the same business formerly conducted by the partnership.

9. The partnership duly and timely filed its tax return for the fiscal year ending January 31, 1961, reflecting taxable income of One Hundred One Thousand Four Hundred Fourteen and 87/100 Dollars (\$101,414.87). Taxpayers

duly reported for the calendar year 1961 their applicable distributive shares of partnership income.

10. Upon examination, the Commissioner determined that for the fiscal year ending January 31, 1961, the partnership should include as taxable income Seventy-three Thousand Twenty-eight and 05/100 Dollars (\$73,028.05), the bad debt reserve applicable to the accounts receivable transferred to the corporations. As a result of this determination, the Commissioner assessed a deficiency for the calendar year 1961 against taxpayers as follows:

James G. Nash and Cecelia Nash.....\$48,473.14

Birmingham Trust National Bank,  
as Trustee for James G. Nash, Jr..... 1,042.96

Birmingham Trust National Bank,  
as Trustee for Margaret Nash..... 1,041.52

11. Taxpayers subsequently paid the deficiencies, plus interest to the date of payment, and timely filed a claim for refund seeking recovery of the deficiencies and interest. Upon denial of the claim for refund within six (6) months after the filing thereof, the taxpayers filed this suit within the statutory period.

Sirote, Permutt, Friend & Friedman  
By Joseph S. Bluestein  
*Attorneys for Plaintiffs*

A. Jerry Busby  
*Attorneys for Defendant*

IN THE UNITED STATES DISTRICT COURT FOR  
THE NORTHERN DISTRICT OF ALABAMA,  
SOUTHERN DIVISION

[Caption Omitted]

FINDINGS OF FACT AND  
CONCLUSIONS OF LAW  
(Filed June 12, 1968)

These actions were consolidated for purpose of trial only and submitted for the final judgment of the court, without the intervention of a jury, upon the pleadings, the order on pretrial hearing, and the stipulations of facts entered into by the attorneys of record for the respective parties hereto, together with the additional oral stipulation in open court that the bad debt reserves involved herein were reasonable in amount. Upon due consideration the court makes and enters the following findings of fact and conclusions of law.

FINDINGS OF FACT

The court finds the facts to be as stipulated in writing and orally.

CONCLUSIONS OF LAW

1. The court has jurisdiction of these actions and of the parties thereto.

2. The opinion in *Estate of Heinz Schmidt, Deceased v. Commissioner*, 355 F.2d 111 (9th Cir. 1966), is precisely in point and persuades the court to decide the issue in favor of the respective plaintiffs.

3. Plaintiff Birmingham Trust National Bank, as Trustee of the Margaret Nash Trust, is entitled to recover of defendant in the amount of \$1,273.73, with interest as allowed by law, from November 2, 1965.

4. Plaintiffs James G. Nash and Cecelia Nash are entitled to recover of defendant in the amount of \$59,256.75, with interest as allowed by law from January 12, 1966.

5. Plaintiff Birmingham Trust National Bank, as Trustee under the James G. Nash, Jr. Trust, is entitled to

recover of defendant in the amount of \$1,274.98, with interest as allowed by law from November 2, 1965.

Separate judgments in favor of plaintiffs are to be entered herein.

Done, this the 12th day of June, 1968.

Seybourn H. Lynne  
Chief Judge

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IN THE UNITED STATES DISTRICT COURT FOR  
THE NORTHERN DISTRICT OF ALABAMA,  
SOUTHERN DIVISION

BIRMINGHAM TRUST NATIONAL  
BANK, as Trustee of the  
Margaret Nash Trust,

*Plaintiff,*

Civil Action  
No. 67-247

vs.

UNITED STATES OF AMERICA,

*Defendant.*

JUDGMENT

(Filed June 12, 1968)

In conformity with the findings of fact and conclusions of law contemporaneously filed herewith:

It is hereby ORDERED, ADJUDGED and DECREED by the court that plaintiff, Birmingham Trust National Bank, as Trustee of the Margaret Nash Trust, have and recover of defendant, United States of America, the sum of \$1,273.73, with interest as allowed by law from November 2, 1965.

Done, this the 12th day of June, 1968.

Seybourn H. Lynne  
Chief Judge

IN THE UNITED STATES DISTRICT COURT FOR  
THE NORTHERN DISTRICT OF ALABAMA,  
SOUTHERN DIVISION

JAMES G. NASH and CECELIA NASH,  
*Plaintiffs,*

vs.

UNITED STATES OF AMERICA,  
*Defendant.*

Civil Action  
No. 67-248

JUDGMENT

(Filed June 12, 1968)

In conformity with the findings of fact and conclusions  
of law contemporaneously filed herewith:

It is hereby ORDERED, ADJUDGED and DE-  
CREED by the court that plaintiffs, James G. Nash and  
Cecelia Nash, have and recover of defendant, United States  
of America, the sum of \$59,256.75, with interest as allowed  
by law from January 12, 1966.

Done, this the 12th day of June, 1968.

Seybourn H. Lynne  
*Chief Judge*

IN THE UNITED STATES DISTRICT COURT FOR  
THE NORTHERN DISTRICT OF ALABAMA,  
SOUTHERN DIVISION

BIRMINGHAM TRUST NATIONAL  
BANK, as Trustee under the  
James G. Nash, Jr., Trust,

*Plaintiff,*

vs.

UNITED STATES OF AMERICA.  
*Defendant.*

Civil Action  
No. 67-249

## JUDGMENT

(Filed June 12, 1968)

In conformity with the findings of fact and conclusions of law contemporaneously filed herewith:

It is hereby ORDERED, ADJUDGED and DECREED by the court that plaintiff, Birmingham Trust National Bank, as Trustee under the James G. Nash, Jr. Trust, have and recover of defendant, United States of America, the sum of \$1,274.98, with interest as allowed by law from November 2, 1965.

Done, this the 12th day of June, 1968.

Seybourn H. Lynne  
Chief Judge

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IN THE  
UNITED STATES COURT OF APPEALS  
FOR THE FIFTH CIRCUIT  
No. 26928

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JAMES G. NASH and CECELIA NASH,  
*Plaintiff-Appellees,*  
versus  
UNITED STATES OF AMERICA,  
*Defendant-Appellant,*

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No. 26929

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BIRMINGHAM TRUST NATIONAL BANK, AS  
TRUSTEE OF THE MARGARET NASH TRUST,  
*Plaintiff-Appellee,*  
versus  
UNITED STATES OF AMERICA,  
*Defendant-Appellant,*

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No. 26930

BIRMINGHAM TRUST NATIONAL BANK, as  
Trustee under the James G. Nash, Jr. Trust,  
*Plaintiff-Appellee,*

versus

UNITED STATES OF AMERICA,  
*Defendant-Appellant.*

*Appeals from the United States District Court for the  
Northern District of Alabama*

(July 2, 1969)

Before TUTTLE and SIMPSON, Circuit Judges, and  
CASSIBRY, District Judge.

TUTTLE, CIRCUIT JUDGE: This appeal presents the issue as to the taxability of a reserve for bad debts, set up by individual taxpayers, upon their transfer of the accounts receivable owned by the taxpayers, to controlled corporations, under §351 of the 1954 Internal Revenue Code.<sup>1</sup>

These consolidated suits were brought to recover federal income taxes for the year 1961. The taxes had been paid by the taxpayers, James G. Nash and his wife by joint return and Birmingham Trust National Bank as trustee

<sup>1</sup> (26 U.S.C. 1964 ed., Sec. 166.) SEC. 351. TRANSFER TO CORPORATION CONTROLLED BY TRANSFEROR. (a) [as amended by Sec. 203(a), Act of Nov. 13, 1966, P. L. 89-809, 80 Stat. 1539] *General Rule.*—No gain or loss shall be recognized if property is transferred to a corporation (including, in the case of transfers made on or before June 30, 1967, an investment company) by one or more persons solely in exchange for stock or securities in such corpo-

under the James G. Nash, Jr. Trust and under the Margaret Nash Trust. These persons were partners operating various finance institutions. In their operation they used the accrual method of accounting and the reserve method of accounting for bad debts.

On June 1, 1960, the partnership separately incorporated eight of its finance businesses in accordance with §351, supra. Among the partnership assets transferred to the controlled corporations were accounts receivable in the total amount of \$486,853.69. This represented the face amount of the accounts receivable. However, the partnership books at that time reflected a reserve for bad debts applicable to the accounts receivable in the amount of \$73,028.05. In setting up the books of account for the new corporation, the accounts receivable were shown at face value and then an item representing the proportionate part of the reserve for bad debts applicable to that particular account was deducted, purportedly then showing the net amount, which taxpayers contend represents the true or net value of the accounts.

The Commissioner determined that the partnership should have included for its final fiscal year ending January 31, 1961, the amount of the bad debt reserve, \$73,028.05, which the partnership had built up during its operation and which at the time of transfer to the corporations had not been used by specific charge-offs.

This case appears to be in all respects similar to the case of *Estate of Schmidt v. Commr.*, (9th Cir., 1968) 355 F.2d 111, in which the Court of Appeals for the Ninth Circuit reversed a decision of the Tax Court which had accepted the Commissioner's position as here urged upon us. In reversing the Tax Court, the Court of Appeals for the Ninth Circuit distinguished prior decisions of its own. *Arcadia Savings & Loan Assn. v. Commr.*, (9th Cir.) 300 F.2d 247 and *West Seattle Natl. Bank v. Commr.*, (9th Cir.) 288 F.2d 47.

ration and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation. For purposes of this section, stock or securities issued for services shall not be considered as issued in return for property.

After carefully considering the analysis made by the Tax Court in its opinion in the Schmidt case (before reversal by the Ninth Circuit) found in 42 T.C. and its subsequent opinion in *Schuster v. Commr.*, 50 T.C. 98, we have concluded that with deference, the Commissioner's position as supported by the Tax Court is sound and should be adopted. We, therefore, respectfully disagree with the judgment and decision of the Court of Appeals announced in *Estate of Schmidt v. Commr., supra.*<sup>2</sup>

The parties agree substantially to the proposition that the setting up of a bad debt reserve by a taxpayer is an accounting practice which permits him to estimate in advance what proportion or percentage of his accounts receivable will not be collected. This system of accounting is recognized by regulations and, so long as the amounts deducted from income are deemed reasonable, they are allowed as a reduction in taxable income. The parties also agree substantially that whenever the need for maintaining such reserve is no longer present, the amount carried as reserve must be covered back into income, because the taxpayer has reduced his tax during the period of accumulation of the reserve and it is only just and proper under the taxing system that it be reported as income when it has fully served its purpose. Of course, generally, this occurs only upon final liquidation or upon sale of assets in a manner that demonstrates that they are worth face value.

The government contends that this rule should be applied with its full vigor here; since it says that when the individuals transferred the accounts receivable to the eight corporations, they, the transferors, could never need such a reserve because the accounts could never become worth less than face value in their hands. The taxpayers counter with the argument that the accounts were really transferred to the newly organized corporation at the *net* value which was

<sup>2</sup> Mertens seems to agree with this treatment. See Mertens Law of Federal Income Taxation, Vol. 3, §20. 45 at page 127. See also Mertens §30.69 at page 132 where the text states: "The taxpayer should bear in mind that when all reason for maintaining a bad debt reserve ceases, the reserve then becomes an item of gross income, citing *S. Rossin & Sons, Inc. v. Commr.*, 113 F.2d (2 Cir., 1940) reversing 40 B.T.A. 1274; *Peabody Coal Co.*, 18 B.T.A. 1080 aff'd 55 F.2d 7

represented by the face of the accounts less the reserve for bad debt.

Taxpayers lay great stress upon the purpose of §351, the section that permits the transfer of property to a corporation in return for a controlling stock ownership in the corporation without a recognition of either gain or loss in the hands of the transferor. It seems to us, however, that the government's position is at least technically correct. Without attempting to be too precise about expressing our views as to the main justification of such a tax free exchange or transfer, §351 is generally thought to permit a transfer in which the economic interests are still such after the transfer as that this is merely a postponement of either gain or loss *to the transferors*, until such gain or loss is actually realized *by them*. Here, where the accounts are received by the new corporations at the basis which they had in the hands of the transferors, it would really amount to a recognition of a loss in the hands of the transferors if they were permitted to "transfer" the reserve for bad debts to the transferee corporations.

Moreover, although the actual amount of tax difference might not be large, the correctness of the government's position seems to be strengthened by the following analysis: the deductions from income by the individual transferors as they annually set aside additions to the reserve resulted in lessening of the tax at individual rates, whereas the ultimate tax paid on any part of the reserve later determined not to be needed by the corporation or upon its decision to abandon the reserve method of accounting will be taxed at corporate rates. This would not be a mere postponement of the incidence of the tax; there would also be a change of the identity of the taxpayer.

Being unable to add to the reasoning of the opinion of the Tax Court in the Schuster case, we conclude that it correctly states the law and upon the basis of the opinion in that case we conclude that the judgment in this court must be REVERSED for the entry of judgment in favor of the United States.

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(7th Cir., 1931) [cert. den., 287 U.S. 605]. The subject is fully discussed on the following page in which at footnote 97(b) reference is made as to the Ninth Circuit decision in the Schmidt case.

**United States Court of Appeals**  
**FOR THE FIFTH CIRCUIT**

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October Term, 1968

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No. 26928

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D. C. Docket No. CA 67-248

**JAMES G. NASH and CECELIA NASH,**  
*Plaintiff-Appellee.*

versus

**UNITED STATES OF AMERICA,**  
*Defendant-Appellant.*

*Appeal from the United States District Court for the  
Northern District of Alabama.*

Before TUTTLE and SIMPSON, *Circuit Judges*, and  
CASSIBRY, *District Judge*.

**JUDGMENT**

This cause came on to be heard on the transcript of the record from the United States District Court for the Northern District of Alabama, and was argued by counsel;

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the judgment of of the said District Court in this cause be, and the same is hereby, reversed.

It is further ordered that plaintiff-appellee pay to defendant-appellant the costs on appeal to be taxed by the Clerk of this Court.

July 2, 1969

Issued as Mandate: July 31, 1969.

# United States Court of Appeals

FOR THE FIFTH CIRCUIT

October Term, 1968

No. 26929

D. C. Docket No. CA 67-247

BIRMINGHAM TRUST NATIONAL BANK, as  
Trustee of the Margaret Nash Trust,

*Plaintiff-Appellee,*

versus

UNITED STATES OF AMERICA,

*Defendant-Appellant.*

*Appeal from the United States District Court for the  
Northern District of Alabama.*

Before TUTTLE and SIMPSON, *Circuit Judges*, and  
CASSIBRY, *District Judge*.

## JUDGMENT

This cause came on to be heard on the transcript of the record from the United States District Court for the Northern District of Alabama, and was argued by counsel:

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the judgment of of the said District Court in this cause be, and the same is hereby, reversed.

It is further ordered that plaintiff-appellee pay to defendant-appellant the costs on appeal to be taxed by the Clerk of this Court.

July 2, 1969

Issued as Mandate: July 31, 1969.

**United States Court of Appeals**  
**FOR THE FIFTH CIRCUIT**

October Term, 1968

No. 26930

D.C. Docket No. CA 67-249

BIRMINGHAM TRUST NATIONAL BANK, as

Trustee under the James G. Nash, Jr. Trust,  
*Plaintiff-Appellee,*

versus

UNITED STATES OF AMERICA,  
*Defendant-Appellant.*

*Appeal from the United States District Court for the  
 Northern District of Alabama.*

Before TUTTLE and SIMPSON, *Circuit Judges*, and  
 CASSIBRY, *District Judge.*

**JUDGMENT**

This cause came on to be heard on the transcript of the record from the United States District Court for the Northern District of Alabama, and was argued by counsel;

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the judgment of of the said District Court in this cause be, and the same is hereby, reversed.

It is further ordered that plaintiff-appellee pay to defendant-appellant the costs on appeal to be taxed by the Clerk of this Court.

July 2, 1969

Issued as Mandate: July 31, 1969.

**Supreme Court of the United States**

No. 678, October Term, 1969

JAMES G. NASH, et al.,

*Petitioners,*

v.

UNITED STATES

Order Allowing Certiorari. Filed January 12, 1970.

The petition herein for a writ of certiorari to the United States Court of Appeals for the Fifth Circuit is granted, and the case is placed on the summary calendar.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

SEP 30 1969

JOHN F. DAVIS, CLERK

IN THE  
**Supreme Court of the United States**

OCTOBER TERM, 1969

NO. **678**

JAMES G. NASH AND  
CECILIA NASH, et al

*Petitioners,*

vs.

UNITED STATES OF AMERICA

*Respondent.*

PETITION FOR A WRIT OF CERTIORARI  
TO THE UNITED STATES COURT OF APPEALS  
FOR THE FIFTH CIRCUIT

MESSRS. SIROTE, PERMUTT,  
FRIEND & FRIEDMAN  
2030 First Avenue North  
Birmingham, Alabama  
*Counsel for Petitioners.*

ALEX W. NEWTON, ESQ.  
City Federal Building  
Birmingham, Alabama  
*Of Counsel*

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IN THE  
**Supreme Court of the United States**

OCTOBER TERM, 1969

NO. \_\_\_\_\_  
\_\_\_\_\_

**JAMES G. NASH AND  
CECILIA NASH, et al**

*Petitioners,*

vs.

**UNITED STATES OF AMERICA**

*Respondent.*

\_\_\_\_\_  
**PETITION FOR A WRIT OF CERTIORARI  
TO THE UNITED STATES COURT OF APPEALS  
FOR THE FIFTH CIRCUIT**  
\_\_\_\_\_

To the Honorable Chief Justice and Associate Justices  
of the Supreme Court of the United States:

The Petitioners pray that a Writ of Certiorari issue to  
review the judgments of the United States Court of Appeals  
for the Fifth Circuit, entered in these causes:

**OPINIONS BELOW**

The opinion of the Court of Appeals, as yet unreported,  
appears at Appendix A, *infra*, pp. 10 to 14. The opinion  
of the United States District Court for the Northern District  
of Alabama, Southern Division, is reported by Commerce

Clearing House in Volume 68-2, U. S. Tax Cases ¶9513. A copy of that opinion is also appended as Appendix B, *infra*, pp. 15 to 21.

## JURISDICTION

The judgments of the Court of Appeals for the Fifth Circuit were entered July 2, 1969. This Petition for Certiorari was filed less than ninety days from the date aforesaid. The jurisdiction of this Court is invoked under 28 U.S.C., §1254 (1).

## QUESTIONS PRESENTED

The primary question involved is whether Petitioners' partnership realized taxable income in the amount of an established reserve for bad debts upon the transfer of accounts receivable to controlled corporations, pursuant to Section 351 of the Internal Revenue Code of 1954, as amended (26 U.S.C., §351).

## STATUTES INVOLVED

"§351. Transfer to Corporation Controlled by Transferor.

"(a) General Rule.—No gain or loss shall be recognized if property is transferred to a corporation (including, in the case of transfers made on or before June 30, 1967, an investment company) by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation. For purposes of this section, stock or securities issued for services shall not be considered as issued in return for property.

"(b) Receipt of Property.—If subsection (a) would

apply to an exchange but for the fact that there is received, in addition to the stock or securities permitted to be received under subsection (a), other property or money, then—

“(1) gain (if any) to such recipient shall be recognized, but not in excess of—

“(A) the amount of money received, plus

“(B) the fair market value of such other property received; and

“(2) no loss to such recipient shall be recognized. . . .”

\* \* \*

### STATEMENT OF THE CASE

These consolidated suits were brought in the District Court for the Northern District of Alabama to recover federal income taxes for the year 1961. Judgments in favor of the Petitioners were entered on June 12, 1968. The government filed its notices of appeal on August 12, 1968 to the Court of Appeals for the Fifth Circuit. Judgments of the District Court were reversed for the entry of judgments in favor of the United States.

Petitioners (James G. Nash and Cecilia Nash and Birmingham Trust National Bank, as Trustee under the James G. Nash, Jr. Trust and under the Margaret Nash Trust) were partners operating various finance businesses. The partnership used the accrual method of accounting and the reserve method of accounting for bad debts.

On June 1, 1960, the partnership separately incorporated eight of its finance businesses in accordance with Section 351 of the Internal Revenue Code of 1954, as amended (which permits tax-free transfers to a controlled corporation). Among the partnership assets transferred to the con-

trolled corporations were accounts receivable in the total amount of \$486,853.69. The partnership books also reflected a reserve for bad debts applicable to the accounts receivable in the amount of \$73,028.05. Petitioners received, in exchange for such transfer, stock and securities, including paid-in surplus, representing the net book value of fixed assets, accounts receivable (reduced by the amount of the reserve in question) and cash transferred.

Upon examination of the partnership return filed for the fiscal year ending January 31, 1961, the Commissioner determined that the partnership should have included as income the amount of the bad debt reserve (\$73,028.05) applicable to the accounts receivable transferred to the corporations on June 1, 1960. This adjustment in the partnership income led to tax deficiencies asserted against Petitioners for the calendar year 1961. Taxpayers paid the deficiencies and brought suits in the District Court after denial of their refund claims.

The three cases were consolidated and submitted to the District Court upon stipulated facts and upon the oral stipulation that the bad debt reserve in question was reasonable in amount. Judge Lynne held, as Petitioners contended, that the partnership was not required to include in its income the amount of the bad debt reserve. This decision was based on the authority of *Estate of Schmidt v. Commissioner*, 355 F. 2d 111 (9th Cir. 1966). The Government appealed from the judgments entered in favor of Petitioners to the Court of Appeals for the Fifth Circuit. The Court of Appeals reversed the judgments of the Petitioners and entered judgments in favor of the United States citing as authority the Tax Court decisions in *Estate of Schmidt*, 42 T.C. 1130, rev'd 355 F. 2d 111 (9th Cir. 1966) and *Schuster v. Commissioner*, 50 T.C. 98 (1968).

## REASONS FOR GRANTING THE WRIT

(1) Directly in conflict with the decision of the Fifth Circuit in the instant cases is the decision of the Court of Appeals for the Ninth Circuit in *Estate of Schmidt v. United States*, 355 F. 2d 111 (1966). The existence of this direct conflict was noted by the Fifth Circuit in its opinion in Appendix A, at p. 12, *infra*. The Fifth Circuit bases its decision on the analysis made by the Tax Court in its opinion in the *Schmidt* case (reversed by the Ninth Circuit) found in 42 T.C. and its subsequent opinion in *Schuster v. Commissioner*, 50 T.C. 98.

(2) The question presented is of utmost importance in the administration of the federal tax laws. The *Schuster* case, *supra*, has been appealed to the Second Circuit Court of Appeals and is presently pending. There is presently pending in the Court of Claims the case of *Morton Jolles*, Docket No. 4014-67, which was filed in December, 1967, and involves this question. There are presently pending in the District Court for the Central District of California the cases of *George Scofield* and *Lefingwell Chemical Co.* involving this issue. In the Court of Appeals for the Sixth Circuit, there is presently pending the case of *Fred W. Rowe*, the decision of the District Court of Kentucky favorable to the taxpayer being reported in Commerce Clearing House Volume 69-1, at paragraph 9162. There are presently pending in the Tax Court of the United States the following cases:

Ritter Finance Co.	Docket No. 1756-68
Robert P. Hutton	Docket No. 1990-68
Israel J. Erlich	Docket No. 4871-67
Leland E. Mock	Docket No. 1493-69
Victor Graber	Docket No. 5846-67

All of the above cases involve the precise question posed in Petitioners' cases.

In addition to the above pending cases, Petitioners have information that there are presently pending before the administrative levels of the Treasury Department nine separate cases involving this same question.

The question is one of both statutory interpretation and judicial precedent. In 1921, Congress enacted the predecessor of Section 351 of the Internal Revenue Code of 1954, as amended. This statute, providing for non-recognition of gain or loss upon the simple transition of a proprietorship or partnership to the form of a corporation, has been a part of the tax law since that time and in virtually the same form.

Petitioners do not agree or have they ever indicated an agreement with the proposition set forth by the Fifth Circuit on page 12 of Appendix A that "whenever the need for maintaining such reserve is no longer present, the amount carried as a reserve must be covered [sic] back into income, because the taxpayer has reduced his tax during the period of accumulation of the reserve. . . ." Petitioners contend that the lack of need is not enough to result in the taxation of the reserve and there must be, in addition thereto, a *recovery*. The first announced position of the Treasury that the reserve for bad debts would be restored to income upon the transfer to a controlled corporation was set forth in Revenue Ruling 62-128, 1962-2, Cum. Bul. 139. The ruling limited its application to situations where additions to the reserve in prior years resulted in a tax benefit. This is essentially the same rule as set forth in Section 111 of the Internal Revenue Code. Under that section, the Commissioner in his regulations specifically requires that in order for taxable income to result there must be a *recovery*. Treas. Reg. §1.111 (a) (2).

The Petitioners respectfully submit that the statement of the Fifth Circuit on pages 13 and 14 in Appendix A relating to the difference in individual rates and corporate rates is, in reality, not relevant to the question presented. The rate of the individual may not always be more than the corporate rate. Furthermore, where bad debt reserves are carried over in corporate readjustments, such as in A, C, D and F reorganizations and subsidiary liquidations, the Commissioner is not concerned that the tax rate of the transferor corporation may be higher than the tax rate of the transferee corporation. Treas. Reg., §1.381(c) (4)-1 (a) (1) (ii). These corporate readjustments involve nothing more than the mere change in the form of a business, similar to the Section 351 transfers to controlled corporations.

(3) The question presented is extremely important to the businessman who seeks to adjust his form of doing business. The reserve method of accounting for bad debts is frequently adopted by the proprietorship or partnership using the accrual method of accounting and contending with accounts receivable of consequence. As these businesses grow, they frequently for valid business reasons change to the corporate form. Congress, in enacting Section 351, sought to reduce interference of the tax laws with "necessary business readjustments." S. Rep. 275, 66 Cong., 1st Sess., p. 10 (1921); (1939 Cum. Bull. 1 (part 21, P. 181, 188-189)). Can the proprietorship or partnership transfer all of its assets and liabilities to the controlled corporation without incurring any tax upon the transfer under the theory of the Ninth Circuit, or must they artificially hold out these receivables and not transfer them to the corporation because of the position adopted by the Fifth Circuit in these cases and the Tax Court?

## CONCLUSIONS

The decision of the Fifth Circuit in these cases and its conflict with the decision of the Ninth Circuit present an uncertain framework for the orderly transfer of proprietorship or partnership to controlled corporation. Furthermore, the failure to review this case will certainly create further confusion as to the direction to be taken in resolving the numerous identical matters pending at the judicial and administrative levels. Accordingly, this Petition for Writ of Certiorari should be granted.

Respectfully submitted,

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ALEX W. NEWTON  
City Federal Building  
Birmingham, Alabama  
*Of Counsel for Petitioners*

SIROTE, PERMUTT, FRIEND & FRIEDMAN  
2030 First Avenue North  
Birmingham, Alabama  
*Of Counsel for Petitioners*

## PROOF OF SERVICE

I, Alex W. Newton, of counsel for Petitioners herein, depose and say that on the — day of September, 1969, I served four copies of the within Petition for Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit on the Respondent herein, the United States of America, by mailing the same to Johnnie M. Walters, Assistant Attorney General, Tax Division, Department of Justice, Washington, D. C. 20530, and one copy of this

Petition upon United States Attorney, by mailing the same to him at Post Office Box 195, Federal Building, Birmingham, Alabama, in envelopes with postage prepaid.

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ALEX W. NEWTON

Sworn to and subscribed before me,  
this — day of September, 1969.

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Notary Public

APPENDIX A  
OPINION OF THE COURT OF APPEALS

**TUTTLE, CIRCUIT JUDGE:** This appeal presents the issue as to the taxability of a reserve for bad debts, set up by individual taxpayers, upon their transfer of the accounts receivable owned by the taxpayers, to controlled corporations, under §351 of the 1954 Internal Revenue Code.<sup>1</sup>

These consolidated suits were brought to recover federal income taxes for the year 1961. The taxes had been paid by the taxpayers, James G. Nash and his wife by joint return and Birmingham Trust National Bank as trustee under the James G. Nash, Jr. Trust and under the Margaret Nash Trust. These persons were partners operating various finance institutions. In their operation they used the accrual method of accounting and the reserve method of accounting for bad debts.

On June 1, 1960, the partnership separately incorporated eight of its finance businesses in accordance with §351, *supra*. Among the partnership assets transferred to the controlled corporations were accounts receivable in the

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<sup>1</sup> (26 U.S.C. 1964 ed., Sec. 166.)

**SEC. 351. TRANSFER TO CORPORATION CONTROLLED BY TRANSFEROR.**

(a) [as amended by Sec. 203(a), Act of Nov. 13, 1966, P.L. 89-809, 80 Stat. 1539]

*General Rule.*—No gain or loss shall be recognized if property is transferred to a corporation (including, in the case of transfers made on or before June 30, 1967, an investment company) by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation. For purposes of this section, stock or securities issued for services shall not be considered as issued in return for property.

total amount of \$486,853.69. This represented the face amount of the accounts receivable. However, the partnership books at that time reflected a reserve for bad debts applicable to the accounts receivable in the amount of \$73,028.05. In setting up the books of account for the new corporation, the accounts receivable were shown at face value and then an item representing the proportionate part of the reserve for bad debts applicable to that particular account was deducted, purportedly then showing the net amount, which taxpayers contend represents the true or net value of the accounts.

The Commissioner determined that the partnership should have included for its final fiscal year ending January 31, 1961 the amount of the bad debt reserve, \$73,028.05, which the partnership had built up during its operation and which at the time of transfer to the corporations had not been used by specific charge-offs.

This case appears to be in all respects similar to the case of *Estate of Schmidt v. Commr.*, (9th Cir., 1968) 355 F.2d 111, in which the Court of Appeals for the Ninth Circuit reversed a decision of the Tax Court which had accepted the Commissioner's position as here urged upon us. In reversing the Tax Court, the Court of Appeals for the Ninth Circuit distinguished prior decisions of its own. *Arcadia Savings & Loan Assn. v. Commr.*, (9th Cir.) 300 F.2d 247 and *West Seattle Natl. Bank v. Commr.*, (9th Cir.) 288 F.2d 47.

After carefully considering the analysis made by the Tax Court in its opinion in the Schmidt case (before reversal by the Ninth Circuit) found in 42 T.C. and its subsequent opinion in *Schuster v. Commr.*, 50 T.C. 98, we have concluded that with deference, the Commissioner's position as supported by the Tax Court is sound and should be

adopted. We, therefore, respectfully disagree with the judgment and decision of the Court of Appeals announced in *Estate of Schmidt v. Commr.*, *supra*.<sup>2</sup>

The parties agree substantially to the proposition that the setting up of a bad debt reserve by a taxpayer is an accounting practice which permits him to estimate in advance what proportion or percentage of his accounts receivable will not be collected. This system of accounting is recognized by regulations and, so long as the amounts deducted from income are deemed reasonable, they are allowed as a reduction in taxable income. The parties also agree substantially that whenever the need for maintaining such reserve is no longer present, the amount carried as reserve must be covered back into income, because the taxpayer has reduced his tax during the period of accumulation of the reserve and it is only just and proper under the taxing system that it be reported as income when it has fully served its purpose. Of course, generally, this occurs only upon final liquidation or upon sale of assets in a manner that demonstrates that they are worth face value.

The government contends that this rule should be applied with its full vigor here, since it says that when the individuals transferred the accounts receivable to the eight corporations, they, the transferors, could never need such

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<sup>2</sup>Mertens seems to agree with this treatment. See Mertens Law of Federal Income Taxation, Vol. 3, §20.45 at page 127. See also Mertens §30.69 at page 132 where the text states: "The taxpayer should bear in mind that when all reason for maintaining a bad debt reserve ceases, the reserve then becomes an item of gross income, citing *S. Rossin & Sons, Inc. v. Commr.*, 113 F.2d (2 Cir., 1940) reversing 40 B.T.A. 1274; *Peabody Coal Co.*, 18, B.T.A. 1080 aff'd 55 F.2d 7 (7th Cir., 1931) [cert. den., 287 U.S. 605]. The subject is fully discussed on the following page in which at footnote 97(b) reference is made as to the Ninth Circuit decision in the Schmidt case."

a reserve because the accounts could never become worth less than face value in their hands. The taxpayers counter with the argument that the accounts were really transferred to the newly organized corporation at the *net* value which was represented by the face of the accounts less the reserve for bad debt.

Taxpayers lay great stress upon the purpose of §351, the section that permits the transfer of property to a corporation in return for a controlling stock ownership in the corporation without a recognition of either gain or loss in the hands of the transferor. It seems to us, however, that the government's position is at least technically correct: Without attempting to be too precise about expressing our views as to the main justification of such a tax free exchange or transfer, §351 is generally thought to permit a transfer in which the economic interests are still such after the transfer as that this is merely a postponement of either gain or loss *to the transferors*, until such gain or loss is actually realized *by them*. Here, where the accounts are received by the new corporations at the basis which they had in the hands of the transferors, it would really amount to a recognition of a loss in the hands of the transferors if they were permitted to "transfer" the reserve for bad debts to the transferee corporations.

Moreover, although the actual amount of tax difference might not be large, the correctness of the government's position seems to be strengthened by the following analysis: the deductions from income by the individual transferors as they annually set aside additions to the reserve resulted in lessening of the tax at individual rates, whereas the ultimate tax paid on any part of the reserve later determined not to be needed by the corporation or upon its decision to abandon the reserve method of accounting will be

taxed at corporate rates. This would not be a mere postponement of the incidence of the tax; there would also be a change of the identity of the taxpayer.

Being unable to add to the reasoning of the opinion of the Tax Court in the Schuster case, we conclude that it correctly states the law and upon the basis of the opinion in that case we conclude that the judgment in this court must be REVERSED for the entry of judgment in favor of the United States.

APPENDIX B  
OPINION OF THE DISTRICT COURT

LYNNE, District Judge: It is hereby stipulated and agreed by and between the parties to the above cases, for the purpose of the trial of the above entitled and numbered cases, that upon the trial of said actions the following facts are admitted and agreed upon by the parties and shall be taken as true without any evidence being produced thereon. However, other and additional proof as to any fact or matter not consistent with the statements contained in this stipulation may be introduced by either of the parties:

1. James G. Nash, Birmingham Trust National Bank, as Trustee under the James G. Nash, Jr., Trust, and Birmingham Trust National Bank, as Trustee under the Margaret Nash Trust, were, during the calendar year 1961, partners in a partnership operating various finance businesses.

2. The partnership operated ten (10) distinct finance operations, eight (8) were conducted in Birmingham and Tuscaloosa, Alabama, and two (2) were conducted in Columbia and Greenville, South Carolina.

3. The partnership had as its taxable year the fiscal year ending January 31.

4. The partnership used the accrual method of accounting for reporting its income, and the reserve method of accounting for bad debts.

5. On June 1, 1960, the eight (8) Alabama finance companies were incorporated into eight (8) separate corporations organized under the laws of the State of Alabama.

6. As of May 31, 1960, the partnership books reflected accounts receivable in the Alabama operations in the face

amount of Four Hundred Eighty-six Thousand Eight Hundred Fifty-three and 69/100 Dollars (\$486,853.69) and a reserve for bad debts applicable thereto in the amount of Seventy-three Thousand Twenty-eight and 05/100 Dollars (\$73,028.05).

7. On June 1, 1960, the partnership transferred to the eight corporations, in compliance with Section 351 of the Internal Revenue Code of 1954, as amended, the following assets and liabilities solely in exchange for the stock and securities shown below:

(a) *Sun Finance Company of Tuscaloosa, Inc.*

Cash .....	\$ 1,411.03
Accounts Receivable .....	\$53,859.27
Less: Reserve for bad debts.....	8,078.89
	<hr/>
	45,780.38
Furniture & Fixtures .....	3,458.73
Less: Reserve for Accumulated Depreciation .....	3,157.94
	<hr/>
	300.79
<b>TOTAL ASSETS .....</b>	<b>\$47,492.20</b>
Liabilities .....	11,449.55
Paid-In Surplus .....	1,042.65
Stock and Securities .....	35,000.00
<b>TOTAL LIABILITIES &amp; CAPITAL...</b>	<b>\$47,492.20</b>

(b) *Nash Finance Company of Birmingham, Inc.*

Cash .....	\$14,006.57
Accounts Receivable .....	\$85,847.52
Less: Reserve for bad debts.....	10,852.46
	<hr/>
	74,995.06
Furniture & Fixtures .....	23,862.77

Less: Accumulated Depreciation 18,956.93

4,905.84

TOTAL ASSETS .....	\$93,907.47
Liabilities .....	16,050.85
Paid-in Surplus .....	856.62
Stocks and Securities .....	77,000.00

TOTAL LIABILITIES & CAPITAL... \$93,907.47

(c) *Sun Finance Company of Birmingham, Inc.*

Cash .....	\$ 1,615.44
Accounts Receivable .....	\$46,885.35
Less: Reserve for bad debts....	<u>7,032.80</u>
	39,852.55

Furniture & Fixtures .....	4,150.41
Less: Accumulated Depreciation	<u>3,038.81</u>

1,111.60

TOTAL ASSETS .....	\$42,579.59
Liabilities .....	\$ 9,952.51
Paid-in Surplus .....	627.08
Stocks and Securities .....	32,000.00

TOTAL LIABILITIES & CAPITAL... \$42,579.59

(d) *Nash Finance Company of Tuscaloosa, Inc.*

Cash .....	\$ 2,363.58
Accounts Receivable .....	\$69,976.11
Less: Reserve for bad debts....	<u>10,496.42</u>
	59,479.69

Furniture & Fixtures .....	3,861.57
Less: Accumulated Depreciation	<u>3,611.89</u>

249.68

TOTAL ASSETS .....

\$62,092.95

Liabilities .....	14,802.31
Paid-in Surplus .....	290.64
Stocks and Securities .....	47,000.00
<b>TOTAL LIABILITIES &amp; CAPITAL...</b>	<b>\$62,092.95</b>

(e) *Key Finance Company of Birmingham, Inc.*

Cash .....	\$ 1,351.06
Accounts Receivable .....	\$62,769.55
Less: Reserve for bad debts .....	9,341.93
	<hr/>
	53,427.62
Furniture & Fixtures .....	3,596.78
Less: Accumulated Depreciation .....	1,643.92
	<hr/>
	1,952.86

<b>TOTAL ASSETS .....</b>	<b>\$56,731.54</b>
Liabilities .....	13,057.40
Paid-in Surplus .....	674.14
Stocks and Securities .....	43,000.00
<b>TOTAL LIABILITIES &amp; CAPITAL...</b>	<b>\$56,731.54</b>

(f) *Gray Finance Company of Birmingham, Inc.*

Cash .....	\$ 2,487.61
Accounts Receivable .....	\$49,989.50
Less: Reserve for bad debts .....	7,498.42
	<hr/>
	42,491.08
Furniture & Fixtures .....	5,225.43
Less: Accumulated Depreciation .....	4,565.09
	<hr/>
	570.34

<b>TOTAL ASSETS .....</b>	<b>\$45,549.03</b>
Liabilities .....	10,635.08
Paid-in Surplus .....	913.95

Stocks and Securities .....	34,000.00
<b>TOTAL LIABILITIES &amp; CAPITAL...</b>	<b>\$45,549.03</b>

(g) *Delta Finance Company of Tuscaloosa, Inc.*

Cash .....	\$ 1,647.23
Accounts Receivable .....	\$58,187.24
Less: Reserve for bad debts....	8,728.09
	<hr/>
	49,459.15

Furniture & Fixtures .....	2,578.21
Less: Accumulated Depreciation	1,765.24
	<hr/>
	812.97

**TOTAL ASSETS** ..... **\$51,919.35**

Liabilities .....	12,314.18
Paid-in Surplus .....	605.17
Stocks and Securities .....	39,000.00

**TOTAL LIABILITIES & CAPITAL...** **\$51,919.35**(h) *Delta Finance Company of Birmingham, Inc.*

Cash .....	\$ 1,226.82
Accounts Receivable .....	\$73,326.93
Less: Reserve for bad debts....	10,999.04
	<hr/>
	62,327.89

Furniture & Fixtures .....	4,671.53
Less: Accumulated Depreciation	3,044.80
	<hr/>
	1,626.73

**TOTAL ASSETS** ..... **\$65,181.44**

Liabilities .....	15,513.84
Paid-in Surplus .....	667.60
Stocks and Securities .....	49,000.00

**TOTAL LIABILITIES & CAPITAL...** **\$65,181.44**

8. After their incorporation, the eight corporations continued to conduct the same businesses formerly conducted by the partnership.

9. The partnership duly and timely filed its tax return for the fiscal year ending January 31, 1961, reflecting taxable income of One Hundred One Thousand Four Hundred Fourteen and 87/100 Dollars (\$101,414.87). Taxpayers duly reported for the calendar year 1961 their applicable distributive shares of partnership income.

10. Upon examination, the Commissioner determined that for the fiscal year ending January 31, 1961, the partnership should include as taxable income Seventy-three Thousand Twenty-eight and 05/100 Dollars (\$73,028.05), the bad debt reserve applicable to the accounts receivable transferred to the corporations. As a result of this determination, the Commissioner assessed a deficiency for the calendar year 1961 against taxpayers as follows:

James G. Nash and Ceceila Nash.....	\$48,473.14
Birmingham Trust National Bank, as	
Trustee for James G. Nash, Jr. ....	1,042.96
Birmingham Trust National Bank, as	
Trustee for Margaret Nash .....	1,041.52

11. Taxpayers subsequently paid the deficiencies, plus interest to the date of payment, and timely filed a claim for refund seeking recovery of the deficiencies and interest. Upon a denial of the claim for refund within six (6) months after the filing thereof, the taxpayers filed this suit within the statutory period.

### Findings of Fact and Conclusions of Law

These actions were consolidated for purpose of trial only and submitted for the final judgment of the court, with-

out the intervention of a jury, upon the pleadings, the order on pretrial hearing, and the stipulations of facts entered into by the attorneys of record for the respective parties hereto, together with the additional oral stipulation in open court that the bad debt reserves involved herein were reasonable in amount. Upon due consideration the court makes and enters the following findings of fact and conclusions of law.

### Findings of Fact

The court finds the facts to be as stipulated in writing and orally.

### Conclusions of Law

1. The court has jurisdiction of these actions and of the parties thereto.
  2. The opinion in *Estate of Heinz Schmidt, Deceased v. Commissioner* [66-1 USTC ¶ 9202], 355 F.2d 111 (9th Cir. 1966), is precisely in point and persuades the court to decide the issue in favor of the respective plaintiffs.
  3. Plaintiff Birmingham Trust National Bank, as Trustee of the Margaret Nash Trust, is entitled to recover of defendant in the amount of \$1,273.73, with interest as allowed by law, from November 2, 1965.
  4. Plaintiffs James G. Nash and Cecilia Nash are entitled to recover of defendant in the amount of \$59,256.75, with interest as allowed by law from January 12, 1966.
  5. Plaintiff Birmingham Trust National Bank, as Trustee under the James G. Nash, Jr. Trust, is entitled to recover of defendant in the amount of \$1,274.98, with interest as allowed by law from November 2, 1965.
- Separate judgments in favor of plaintiffs are to be entered herein.

# **In the Supreme Court of the United States**

**OCTOBER TERM, 1969**

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**No. 678**

**JAMES G. NASH AND CECILIA NASH, ET AL., PETITIONERS**

**v.**

**UNITED STATES OF AMERICA**

---

**ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED  
STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT**

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## **MEMORANDUM FOR THE UNITED STATES**

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During 1961, petitioners were members of a partnership operating eight finance organizations in Alabama and two in South Carolina. The partnership reported its income on the accrual method of accounting and used the reserve method of accounting for bad debts permitted by Section 166(c) of the Internal Revenue Code and Treasury Regulations, Section 1.166-4.

Under this method, a taxpayer maintains a reserve account, the balance of which is to be adjusted at the end of each year, so that it equals that portion of current accounts receivable that is reasonably estimated to become worthless in subsequent years. Any additions necessary to increase the reserve to its required

level are currently deductible. When accounts receivable become worthless during the year, the reserve account is decreased and no additional deduction is allowed. As of May 31, 1960, petitioners' partnership books reflected accounts receivable for the Alabama organizations of \$486,853.69 and a reserve for bad debts of \$73,028.05 (Pet. App. B 15-16).

On June 1, 1960, petitioners formed eight new corporations and transferred the assets of the eight Alabama organizations, including the accounts receivable, to these corporations in exchange for the latter's stock. The transfer was within the terms of Section 351 of the Internal Revenue Code, which provides that no gain or loss shall be recognized on transfers of property to a corporation in exchange for stock, if, immediately after the exchange, the transferors possess at least 80 percent control of the corporation.

The issue here is whether the balance remaining in petitioners' reserve for bad debts account, which had been deducted from prior years' income, but which represented petitioners' estimate of current accounts receivable that would become worthless in subsequent years, should be restored to income in the year of the transfer of the partnership assets, because the need for the reserve terminated upon the transfer.

The district court held that the amount of the outstanding reserve for bad debts did not have to be restored to petitioners' income for the year of the transfer (Pet. App. B, pp. 15-21). On the Government's appeal, the Fifth Circuit reversed (Pet. App. A, pp. 10-14). The Ninth Circuit considered the iden-

tical question in *Estate of Schmidt v. Commissioner*, 355 F. 2d 111; and held to the contrary, i.e., that the bad debt reserve of a proprietorship did not have to be restored to income in the year of a Section 351 transfer of all of its assets to a corporation.

Because the incorporation of a proprietorship or partnership is a commonplace transaction, the question presented is a recurring one in the administration of the Code.<sup>1</sup> In view of the conflict between the courts of appeals, it is unlikely that a settled rule will be established except through review by this Court. Accordingly, respondent does not object to the granting of the petition.

Respectfully submitted,

ERWIN N. GRISWOLD,  
*Solicitor General.*

OCTOBER, 1969.

<sup>1</sup>The Internal Revenue Service has advised that the cases listed by petitioners (Pet. 5) all present the issue involved in the instant case. Taxpayers in *Schuster v. Commissioner*, 50 T.C. 98, however, have dismissed their appeal to the Second Circuit. The Commissioner's position has again been recently sustained by the Tax Court in *Hutton v. Commissioner*, 53 T.C. No. 6 (decided October 13, 1969). *Scofield v. United States* (Pet. 5), decided adversely to the Government in the United States District Court for the Central District of California March 3, 1969 (69-1 U.S.T.C., par. 9386), is presently pending in the Ninth Circuit on appeal.

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# **In the Supreme Court of the United States**

OCTOBER TERM, 1969

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No. 678

JAMES G. NASH, ET AL., PETITIONERS

VS.

UNITED STATES

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*ON WRIT OF CERTIORARI TO THE UNITED  
STATES COURT OF APPEALS FOR  
THE FIFTH CIRCUIT*

---

**BRIEF FOR THE PETITIONERS**

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## **OPINIONS BELOW**

The opinion of the District Court (A. 12)<sup>1</sup> is unofficially reported at 68-2 U.S.T.C. ¶9513 and 22 A.F.T.R. 2d 5202. The opinion of the Court of Appeals (A. 15) is officially reported at 414 F.2d 627 (5th Cir. 1969).

## **JURISDICTION**

The Judgments of the Court of Appeals (A. 20-22) were entered on July 2, 1969. The petition for a writ of certiorari was filed on September 30, 1969, and certiorari was granted on January 12, 1970. The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

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<sup>1</sup> "A" references are to the separately bound Appendix.

## QUESTION PRESENTED

Whether taxpayers' partnership realized taxable income in the amount of its reserve for bad debts, upon the transfer of accounts receivable and other assets to newly-formed corporations controlled by it, pursuant to Section 351 of the Internal Revenue Code.<sup>2</sup>

## STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of Sections 166, 351, 362, and 1016 of the Internal Revenue Code and of the Treasury Regulations promulgated thereunder are set forth in the Appendix hereto at pages 36 to 49.

## STATEMENT

Taxpayers (James G. Nash and Birmingham Trust National Bank, as Trustee under the James G. Nash, Jr. Trust and under the Margaret Nash Trust)<sup>3</sup> were partners operating various finance businesses. The partnership used the accrual method of accounting and the reserve method of accounting for bad debts. (A. 7).

On June 1, 1960, the partnership separately incorporated eight of its finance businesses in accordance with Section 351 of the Internal Revenue Code. The taxpayers' partnership received, in exchange for such transfer, stock and securities, including paid-in surplus, representing the net book value of fixed assets, accounts receivable (reduced by the amount of the reserve for bad debts in question)

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<sup>2</sup> All references are to the Internal Revenue Code of 1954, as amended, unless otherwise stated.

<sup>3</sup> We omit reference to Cecelia Nash, who is a party in No. 26,928, only because of the filing of a joint return.

and cash transferred.<sup>4</sup> The corporations continued to conduct the same businesses formerly conducted by the partnership.

The taxpayers, in their partnership return filed for the fiscal year ending January 31, 1961, did not recognize any gain or income upon the transfers to the controlled corporations. Upon the examination of the partnership return, the Commissioner of Internal Revenue determined that the amount of the bad debt reserve (\$73,028.05) applicable to the accounts receivable transferred to the corporations on June 1, 1960, should be included as income to the partnership. This adjustment in the partnership income led to tax deficiencies asserted against the taxpayers for the calendar year 1961.

The taxpayers paid the resulting deficiencies and later instituted these suits for refund (A. 11). The three cases were consolidated and submitted to the District Court upon stipulated facts (A. 6) and upon the oral stipulation that the bad debt reserve in question was reasonable in amount. (A. 12). The District Court decided for the taxpayers on the authority of *Estate of Schmidt v. Commissioner*, 355 F.2d 111 (9th Cir. 1966) which the District Court found to be precisely in point (A. 12). The Fifth Circuit reversed, finding for the Government on the reasoning expressed by the Tax Court in *Schuster v. Commissioner*, 50 TC. 98 (1968) (A. 18).

This Court granted the taxpayers' petition for certiorari on January 12, 1970.

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<sup>4</sup> The Record (A. 7-10) provides a breakdown of the accounts receivable and reserve for bad debts in respect to each of the eight finance businesses. No significance is attached by the parties to the existence of eight transferees, and the question presented is dealt with herein as it applies to the transfer in total.

## ARGUMENT

### INTRODUCTION AND SUMMARY

The taxpayers' partnership reflected on its books a reserve for bad debts in the amount of \$73,028.05 applicable to accounts receivable on May 31, 1960. The question in this case is whether this reserve for bad debts must be taken into the income of the partnership upon the incorporation of its businesses on June 1, 1960, in transactions qualifying for non-recognition of gain or loss under Section 351 of the Internal Revenue Code.

The taxpayers' partnership operated a number of finance businesses. It used the accrual method of accounting and, thus, recognized income at the time a loan was reflected on its books as an account receivable. Not all loans or receivables were expected to be collected. The taxpayers' partnership accounted for its bad debts, both expected and actual, by use of a bad debt reserve pursuant to Section 166 of the Internal Revenue Code. Under this approach, the reserve was established on the books of the partnership in the amount necessary to reflect the value of its estimated uncollectible accounts receivable. A deduction from income was taken for this amount, and for any subsequent additions to the reserve. The reserve was reviewed annually and additions made thereto as necessary. It has been stipulated by the parties that the amount reflected in the reserve for bad debts in question at the time of the transfer on June 1, 1960 of the businesses to controlled corporations, solely for stock or securities, was reasonable in amount (A. 12).

The statutory scheme for the non-recognition of gain or loss upon the incorporation of businesses is generally contained in Section 351 of the Internal Revenue Code. In summary, it provides that no gain or loss is to be recognized if property is transferred to a controlled corporation solely in exchange for stock or securities. This has been the law,

substantially, since 1921. In 1962 the Commissioner, without prior judicial or legislative authority, took the position that, notwithstanding Section 351, a reserve for bad debts would be restored to the income of a proprietor or partnership, upon the incorporation of its business, on the grounds that the reserve was not transferable and the need for it thereby ceased. Rev. Rul. 62-128, 1962-2 C.B. 139.

The Ninth Circuit, reversing the Tax Court, in 1966 rejected the Commissioner's position in the first case to consider this question, and in the present case, the Fifth Circuit, relying on the Tax Court, approved his position.<sup>5</sup>

We contend that Section 351 precludes the recognition of income by the partnership. The legislative history of this Section, which we review in point I of our brief, shows that Congress provided for non-recognition of gain or loss, as a deferral rather than an exemption from taxation, because the incorporations of existing businesses were "merely changes in form and not in substance, and consequently should not be considered as affecting a realization of income at the time of exchange."<sup>6</sup> This Court considered Section 351, as found in prior law, to be designed to permit such business "readjustments" without the recognition of gain or loss. *Helvering v. Cement Investors, Inc.*, 316 U.S. 527 (1942).

As illustrated by this Court in *Helvering v. Cement Investors, Inc.*, there exists a close relationship, both in origin and in purpose, between Section 351 covering the incorporation of a business and the provisions of the law relating to corporate reorganizations. Reserves for bad debts are

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<sup>5</sup>*The Estate of Schmidt v. United States*, 355 F.2d 111 (9th Cir. 1966), reversing 42 T.C. 1130; *Schuster v. Commissioner*, 50 T.C. 98 (1968).

<sup>6</sup>H. Rep. 179, 68th Cong. 1st Sess. 16 (1924); S. Rep. 275, 67th Cong. 1st Sess. 10 (1921).

not taken into income by corporations transferring their businesses in non-taxable reorganizations. The reserve is simply carried over by the corporation acquiring the business. We maintain in point II of our brief that the same rules should apply to transfers of existing businesses under the provisions of Section 351. The Tax Court, relied upon by the court below, distinguished between the corporate organization and the corporate reorganization on the basis that they found what they considered to be specific statutory language allowing the carryover of the bad debt reserve in the reorganization transaction, but could find none for the 351 transfer. The only statutory language that could be pertinent to the reorganization is Section 381 (c) (4) added to the Internal Revenue Code of 1954. This Section requires the acquiring corporation in a reorganization to continue the method of accounting used by the transferor corporation, unless different methods were previously used. Legislative history reveals that Congress passed this Section to clear up uncertainties which had arisen through court decisions at that time, and it was specifically stated that the Section was not intended to be exclusive. Moreover, without specific statutory authority, the carryover of tax attributes from one corporation to another in a reorganization was allowed prior to the enactment of Section 381. See *Helvering v. Metropolitan Edison Co.*, 306 U.S. 522 (1939); *Commissioner v. Sansome*, 60 F.2d 931 (2nd Cir. 1932). In the 351 situation, the Commissioner has ample authority to require either that the reserve be carried over by the incorporating business or that necessary adjustments be made to clearly reflect income, if it not be. Treas. Reg. Section 1.166-1 (b) (1); *Rooney v. U.S.*, 305 F.2d 681 (9th Cir. 1962); *Commissioner v. Kuckenberg*, 309 F.2d 202 (9th Cir. 1962).

In the alternative, in point III, we contend that the proper test for restoring the reserve for bad debts to taxable in-

come is one predicated on a recovery by the taxpayer of the amount of the reserve, and not the lack of a need as found by the court below. With the reserve being reasonable, the true value of the accounts receivable was their face value less the amount of the reserve. The value of the stock and securities received by the partnership upon the transfer of the businesses was equal to the net value of the receivables and, therefore, there was not any recovery of the amount of the reserve.

We also urge that the decision of the court below, if not reversed, will paradoxically create income in a tax-free environment, where no income would be realized to a partnership in a taxable transaction if the receivables were sold to a third party at net value—the face value of the accounts receivable less the amount of the reasonable reserve for bad debts. The lower court's result would in effect, create income to the taxpayer where none would have been created if the business had continued in its partnership form and ultimately charged those accounts which became uncollectible to the reasonable reserve which it established. In addition, the restoration of the reserve to income by the partnership and new deductions to the transferee controlled corporation will distort the income of all parties involved in the incorporation of businesses, and will offend the intent and purpose of the reserve method.

**I. TRANSFERS TO CONTROLLED CORPORATIONS UNDER SECTION 351 ARE MERE CHANGES IN FORM AND NOT IN SUBSTANCE, AND DO NOT, THEREFORE, GIVE RISE TO INCOME TAX CONSEQUENCES.**

The transfers by the partnership to the corporations were in compliance with Section 351 of the Internal Revenue Code (A. 7). Section 351 provides, in the portion pertinent to the issue before the Court, that:

No gain or loss shall be recognized if property is

transferred to a corporation . . . by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control . . . of the corporation . . .<sup>7</sup>

With certain changes which are not pertinent to our problem, all of the Revenue Acts enacted since 1921 have contained provisions substantially similar to Section 351.<sup>8</sup>

In the Revenue Act of 1921, Congress first provided for nonrecognition of gain or loss upon the transfer of property to a controlled corporation. Section 202(c)(3). Congress, also for the first time therein, enacted a definition of "reorganization" and provided for no gain or loss upon an exchange of securities incident to such a corporate reorganization. Section 202(c)(2). In addition, Congress provided for nonrecognition of gain or loss upon the exchange of investment property for like kind or use (the forerunner of the present Section 1031). Section 202(c).

Congress' intention in enacting this section is clearly set forth in the following excerpt from the committee reports:

*Section 202 (subdivision (c)) provides now rules for those exchanges or 'trades' in which, although a technical 'gain' may be realized under the present law, the taxpayer actually realizes no cash profit.*

*Under existing law, 'when property is exchanged for other property, the property received in exchange shall, for the purpose of determining gain or loss, be treated as the equivalent of cash, to the amount of its fair market value, if any \* \* \*.' Probably no part of the present income tax law has been productive of so much uncertainty or has more seriously interfered with necessary business readjustments. The existing law makes*

<sup>7</sup> Section 351 is set out in pertinent part in the Appendix hereto at p. 38.

<sup>8</sup> The Revenue Act of 1921, §202(c) is set forth in full in the Appendix at pp. 42-44. The sections for the respective years are: Int. Rev. Code of 1939, §112(b)(5), 53 Stat. 37; Revenue Act of

a presumption in favor of taxation. The proposed act modifies that presumption by providing that in the case of an exchange of property for property no gain or loss shall be recognized unless the property received in exchange has a readily realizable market value, and *specifies in addition certain classes of exchanges on which no gain or loss is recognized even if the property received in exchange has a readily realizable market value.* These classes comprise the cases where productive property (other than stock in trade or property held primarily for sale) used in a trade or business is exchanged for property of a like kind or use; where in any corporate reorganization or readjustment stock or securities are exchanged for stock or securities of a corporation which is a party to or results from such reorganization; and *where an individual or individuals transfer property to a corporation and after such transfer are in control of such corporation.*

*The preceding amendments, if adopted, will, by removing a source of grave uncertainty and by eliminating many technical constructions which are economically unsound, not only permit business to go forward with readjustments required by existing conditions but also will considerably increase the revenue by preventing taxpayers from taking colorable losses in wash sales and other fictitious exchanges.* . . . (S. Rep. 275, 67th Cong. 1st Sess. 10 (1921)); [Emphasis added].

In connection with the review of a corporate readjustment which did not meet the literal language of the reorganization definition under the Revenue Act of 1936, this Court found Section 112(b)(5) of the Act, which is the predecessor of our Section 351, to be applicable and "to permit the

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1938, §112(b)(5), 52 Stat. 485; Revenue Act of 1936, §112(b)(5), 49 Stat. 1679; Revenue Act of 1934, §112(b)(5), 48 Stat. 704; Revenue Act of 1932, §112(b)(5), 47 Stat. 196; Revenue Act of 1928, §112(b)(5), 45 Stat. 816; Revenue Act of 1926, §203(b)(4), 44 Stat. 12; Revenue Act of 1924, §203(b)(4), 43 Stat. 256; Revenue Act of 1921, §202(c)(3), 42 Stat. 230.

deferral of gains or losses where 'there has been a mere change in the form of ownership' or where the taxpayer has not 'closed out a losing venture.'" *Helvering v. Cement Investors, Inc.*, 316 U.S. 527, 533 (1942).<sup>\*</sup>

As this Court commented in that case concerning one of the forerunners of Section 351:

Its legislative history shows that it was designed to permit 'readjustments' without present recognition of gain or loss by allowing property to be transferred to a controlled corporation by an individual, a partnership, a corporation or others. (p. 533)

In 1924, when considering a new Revenue Act setting forth the provisions for the carry-over of bases of property acquired in the tax-free transfers previously referred to under the 1921 Revenue Act, Congress had occasion to restate the purposes underlying the enactment of these tax-free transfers:

*The provisions . . . that no gain or loss is recognized from certain exchanges do not grant an exemption and are not so intended. These provisions are based upon the theory that the types of exchanges specified . . . [§202(c), Rev. Act. 1921] are merely changes in form and not in substance, and consequently should not be considered as affecting a realization of income at the time of exchange. In other words, these provisions result not in an exemption from tax but in a postponement of tax until the gain is realized by a pure sale or*

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<sup>\*</sup> This Court cited with approval *Portland Oil Co. v. Commissioner*, 109 F.2d 479 (1st Cir. 1940). The First Circuit in *Portland Oil* stated at page 48: "It is the purpose of [351] to save the taxpayer from an immediate recognition of a gain or to intermit the claim of a loss, in certain transactions where a gain or a loss may have accrued in a constitutional sense, but where in a popular and economic sense there has been a mere change in the form of ownership and the taxpayer has not really 'cashed in' on the theoretical gain, or closed out a losing venture."

by such an exchange as amounts to a pure sale. It follows, therefore, that in the case of such an exchange the property received should be considered as taking the place of the property exchanged. (H. Rep. 179, 68th Cong. 1st Sess. 16 (1924). See, also, S. Rep. 398, 68th Cong. 1st Sess. 17 (1924).) [Emphasis supplied]<sup>10</sup>

The position of the taxpayers is fully supported by the literal language of Section 351. The Section begins with the wording: "No gain or loss shall be recognized *if property is transferred to a corporation. . . .*" [Emphasis supplied] Congress chose the words "if, property is transferred" as opposed to "on the transfer of property" or "from the transfer of property." The use of the word "if" connotes *an event* calling for non-recognition of gain, loss or income. It does not simply focus on whether there be gain or loss specifically related to the property involved.

The purpose and meaning of Section 351 had been further manifested by the regulations under Section 453, dealing with the installment method of reporting income. Under this method, taxpayers generally can elect to report gain as cash payments are received, when they fit certain tests provided in Section 453. Taxpayers using the installment method must accelerate their reporting of income upon the disposition of the installment obligation. Section 453(d). The Commissioner's regulations, almost continuously since 1928, have provided that transfers of installment obligations to corporations under Section 351 and in reorganizations, are exceptions to the general rule, and no gain or loss is recognized.<sup>11</sup> The position of the regulations is obviously based on the discussion of the House Ways & Means Com-

<sup>10</sup> This is the forerunner of §362 of the present Internal Revenue Code.

<sup>11</sup> Treas. Reg., §1,453-9(c)(2) was not in Regulation 86 under the Revenue Act of 1932. It did, however, appear thereafter and continuously since that time.

mittee of Section 44(d) of the Revenue Act of 1928, the predecessor of present Section 453(d):

Whether or not a gain or loss realized under the section is recognized for tax purposes depends upon general principles of law embodied in the income tax provisions, the exchange of installment obligations in connection with tax-free exchanges, for instance being cared for by Section 112. [Section 112(b)(5) was one of the predecessors of Section 351.] H. Rep. No. 2, 70th Cong. 1st Sess. 15 (1927). The same was repeated by the Senate Finance Committee S. Rep. 960, 70th Cong. 1st Sess. 24 (1928).

For many years, the courts sought and did preserve the integrity of Section 351, and the tax-free nature of any transfers thereunder where only stock or securities was received in exchange for property transferred. *P. A. Birren & Son v. Commissioner*, 116 F.2d 718 (7th Cir. 1940); *Easson v. Commissioner*, 294 F.2d 653 (9th Cir. 1961).<sup>12</sup> We do not mean to imply that every transfer under Section 351 had been insulated by the courts from taxation. But in those cases where tax consequences resulted, the Commissioner was asserting that the transfer produced an unacceptable assignment of income, or the method of accounting previously followed by the transferor did not clearly reflect income. The Commissioner was then relying on Sections 446 or 482 or their predecessors in the law. *Commissioner v. Kuckenberg*, 309 F.2d 202 (9th Cir. 1962); *Rooney v. United States*, 305 F.2d 681 (9th Cir. 1962). This is not the position of the Commissioner in our case. There is no contention of any assignment of income or any lack of clarity in reflecting income. The amount of the reserve for bad debts is expressly stipulated to be reasonable. (A. 12.)

<sup>12</sup> See also *Estate of Willett v. Commissioner*, 365 F.2d 760 (5th Cir. 1966) and *Henry McK. Haserot, et al*, 41 T.C. 562 (1964), rem'd., 355 F.2d 200; remanded 46 T.C. 864; aff'd. 399 F.2d 828 (6th Cir. 1968).

With this legislative, judicial and regulatory background, it was understandable why the Tax Bar was surprised when the Internal Revenue Service issued, in 1962, Revenue Ruling 62-128. See Arent, *Reallocation of Income and Expenses in Connection with Formation and Liquidation of Corporations*, 40 Taxes, December, 1962, p. 995. This was the first indication of the Revenue Service's position, although the tax-free incorporation sections and the provision providing for the use of the reserve for bad debts had been in the law for over 40 years.<sup>13</sup>

The reserve method selected by taxpayers' partnership to provide deductions for losses from bad debts had also become a part of the law by virtue of the Revenue Act of 1921. Section 214(a)(7).<sup>14</sup>

The reserve method, as contrasted with the specific charge-off system, is designed to match the bad debt deduc-

<sup>13</sup> Apparently the tax writers were not aware that any potential problem existed of this nature in a §351 transaction for a representative review of the articles to that time reveals no discussion of the problem. Here is a cross-section of articles dealing with §351, none of which refers to this danger: Darrell, *Corporate Organizations and Reorganizations Under the Internal Revenue Code of 1954*, 32 Taxes, December 1954, p. 1007; Kumler, *Corporate Organizations and Reorganizations*, U. So. Cal. 1955 Tax Inst. 311; Constellow, *Incorporation of the Unincorporated Enterprise*, N.Y.U. 13th Inst. on Fed. Tax (1955) 685; Webster, *A Tax Check List on Incorporation*, 35 Taxes, August 1957, p. 586; Pennell, *Tax Planning at the Time of Incorporation*, 35 Taxes, December 1957, p. 927; Tritt and Spencer, *Current Tax Problems in Incorporation of a Going Business*, U. So. Cal. 1958 Tax Inst. 71; Paul and Kalish, *Transition from a Partnership to a Corporation*, N.Y.U. 18th Inst. on Fed. Tax 639 (1960); Stutsman and Engman, *Tax Factors in Organizing a Corporation*, P-H Tax Ideas, §7006, April 1962.

<sup>14</sup> It was intended to set forth a method of providing for bad debts "much less subject to abuse than the method of writing off bad debts required by the present law." [Prior thereto, debts were to be charged off when worthless.] H. Rep. 350, 67th Cong., 1st Sess. 11.

tion, with the recognition of the accounts receivable into income. Without the reserve method, receivables would give rise to income in one period, but the worthlessness of the very same receivable, when later determined, could only be claimed in the later period. It was to permit the taxpayer to match expenses with income that the reserve method of accounting was authorized. S. Rep. 275, 67th Cong., 1st Sess. 14 (1921) sets forth this intent:

[L]osses occurring in one year are frequently not determined or sustained until another year, depending upon court decision or the clearing up of uncertainty. To permit more elastic treatment of such losses, in the interest of justice to the taxpayer, it is provided that certain losses shall not be deducted as of the taxable year in which sustained, if, in the opinion of the Commissioner, they should be accounted for as of a different period. . . .

Because it more realistically determines the profit or loss for a given accounting period, the use of the reserve method for bad debts is preferred from an accounting standpoint.<sup>15</sup>

The Ninth Circuit in 1966 was the first appellate court

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<sup>15</sup> Niswonger and Fess, *Accounting Principles* 226 (9th ed. 1965). The case of *O. P. Lutz*, 29 T.C. 469, 475 (1957) contains the following discussion of the two approaches available for accounting for bad debts:

" . . . [T]he Code and previous Revenue Acts have permitted taxpayers to claim deductions in computing their income for accounts that become worthless. Two systems or methods are permitted in determining the amount of such deductions. One system is the direct charge-off method which, . . . required a taxpayer to ascertain which of his accounts receivable were, in fact, worthless, and, specifically, to charge them off during the year when they become so. Under the reserve system of claiming deductions for worthless accounts, a taxpayer is permitted to estimate what percentage of his total accounts receivable would become worthless; to set up a reserve to cover such accounts; and to deduct each year the net addition to the reserve which is necessary in order to maintain it at an adequate level to cover those

to consider the question of whether the amount of the reserve for bad debts must be taken into the income of the transferee upon a transfer under Section 351. *Estate of Schmidt v. Commissioner*, 355 F.2d 111 (9th Cir. 1966), rev'g 42 T.C. 1130 (1964). The court found for the taxpayer, reversing the Tax Court. The Ninth Circuit considered it remarkable that no reported case had been found prior to the one under their consideration in which the Commissioner had taken his position. The court stated: "Yet there must have been literally thousands of businesses transferred by taxpayers to corporations in exchange for stock in which the transferring taxpayer used the reserve method of accounting for bad debts. It was not until the revenue ruling that we have quoted that the Commissioner took a published position on the question."<sup>16</sup> The government in their response to our petition recognized that "the incorporation of a proprietorship or partnership is a commonplace transaction" and that "the question presented is a recurring one in the administration of the Code. . . ."

The published position of the Commissioner, in Revenue Ruling 62-128, provides:

A taxpayer, engaged in a business as a sole proprietor, transferred all of the assets of his business, subject to its liabilities, to a corporation controlled by the transferor in a nontaxable exchange under the provisions of section 351 of the Internal Revenue Code of 1954. Prior

accounts which he expects to become worthless. Under the reserve system, a taxpayer may not be entitled to claim a bad debt deduction every year because of the fact that the amount of his reserve, as it stands at the end of the year, may be adequate to cover all outstanding accounts which reasonably could be expected to become worthless in the light of his recovery experience." see also *Union National Bank of Youngstown v. United States*, 237 F.Supp. 753 (D.C. Ohio 1965), for another discussion of the reserve for bad debts.

<sup>16</sup> 355 F.2d 111, 112-113.

to the transfer, the business had, on its books of account, a reserve for bad debts which had been accumulated by additions for which the taxpayer had derived full tax benefits in prior taxable years. *Held*, under these circumstances the reserve for bad debts is not transferable to any other entity. Accordingly, the reserve for bad debts represents ordinary income to the taxpayer for the taxable year during which the transfer of the accounts receivable was made since, during such time, his need for the reserve ceased. See *Geyer, Cornell & Newell, Inc. v. Commissioner*, 6 T.C. 96, acquiescence, C.B. 1946-1, 2; Rev. Rul. 57-482, C.B. 1957-2, 49; and *C. Standlee Martin, Inc. v. Riddell*, 56-2, U.S.T.C. 9989, 51 A.F.T.R. 1376. Under similar circumstances, a partnership must likewise include such reserve for bad debts in its final return as ordinary income. However, to the extent that the additions to the reserve for bad debts in prior years may not have resulted in tax benefits, they need not be included in the transferors gross income. See *M. & E. Corporation v. Commissioner*, 7 T.C. 1276, acquiescence, C.B. 1947-1, 3.<sup>17</sup>

Revenue Ruling 62-128 is incorrect.<sup>18</sup> As we will discuss

<sup>17</sup> Rev. Rul. 62-128, 1962-2 C.B. 139 (1962).

<sup>18</sup> The Commissioners position has produced a number of critical comments: Arent, *Reallocation of Income and Expenses in Connection with Formation and Liquidation of Corporations*, 40 Taxes, December, 1962, p. 995; Hickman, *Incorporation and Capitalisation*, 40 Taxes, December, 1962, p. 974; 1966 U. Ill. L.F. 787; 66 Colum. L.Rev. 1186 (1966); Blanc, *The Tax Treatment of Reserves Upon a Change in the Form of Doing Business*, 1967 Tax Inst. 433; 6 San Diego L.Rev. 291 (1969); 53 Minn. L.Rev. 1354 (1969); 1969 Duke L. J. 1294; For a general discussion of this question, see Bonovitz, *Restoration to Income of Bad Debt Reserves*, 44 Taxes, May 1966, p. 300; Stoffel, *Treatment of Reserve Accounts on Incorporation and Liquidation*, N.Y.U. 26th Inst. on Fed. Tax 773 (1968).

in point III of this brief, the amount of the reserve for bad debts represents ordinary income to a taxpayer in the taxable year during which he recovers the amount of the accounts which were thought to be bad, not when the "need for the reserve ceased" though the two can coincide at the same time. However, if we were to assume for the purpose of argument, that the recovery into ordinary income is predicated on the cessation of the taxpayer's need for the reserve, the taxpayer's need continues in a Section 351 transfer.

The Revenue Ruling totally disregards the principle and purpose of Section 351 and the bad debt reserve. The transfer to the taxpayers' corporations was merely a change in the form and not in the substance of the business and was a mere readjustment. Economic realities of the situation reflect a continuing need in the business for the reserve, since the value of the taxpayers' stock and securities is predicated on the value of the receivables on the books and records of the corporations.

When the bad debt reserve is conceded to be reasonable (A. 12), losses in such amount can ultimately be expected to occur. The application of the Revenue Ruling would thus reach for income in circumstances where none has been or ever will be realized; for the reserve will be entirely absorbed as the debts prove uncollectible. This would, in effect, create income to the taxpayer where none would be created if the businesses had continued in partnership form and ultimately charged those accounts which became uncollectible to the reasonable reserve which it maintained.

The result urged by the Government would be paradoxical indeed, for the enactment of a statute designed to avoid the recognition of gain or loss will have the effect of having precipitated income in a situation where no income exists and where, without Section 351, no income would have been recognized. With receivables in the amount of \$486,-

853.69 and a reserve in the amount of \$73,028.05, the net receivables which the taxpayers' partnership owned prior to incorporation was \$413,825.64. Had these receivables been transferred in a taxable transaction, no income would have been realized because a buyer would obviously not pay any more for receivables than their collectible amount of \$413,825.64. It follows that without Section 351 and thus with a taxable exchange, no income, gain or loss, would have been realized to the taxpayers' partnership upon the transfer of its receivables to the transferee corporations for the latter's stock, because the fair market value of the stock received for the receivables was necessarily no more than their net collectible amount. It would be paradoxical indeed if the existence of a statute such as Section 351, which was intended to prevent the recognition of income, would have the effect of causing the recognition of income.

Revenue Ruling 62-128 will, if applied, distort both the income of any partnership or proprietorship making a transfer, and the income of the transferee corporation. If he be correct in Revenue Ruling 62-128, the Commissioner must agree that a transferee corporation would be entitled to establish the reserve for bad debts on its books in the first year and charge the amount thereof against income, since the amount was reasonable but was not carried over. This would work a grave distortion of the income of the transferor and of the transferee. The taxpayer would have income through the recovery of the reserve in the year the transfer is made, even though he may have no other sales or business activity in that year, other than the transfer to the controlled corporation. The taxpayer will be required to restore to income any reserve for debts which have not yet been collected and for which he has received no consideration tantamount to the recovery of the debt. All that taxpayers in Section 351 transactions receive are shares of stock or securities equal in value to the net worth of the

accounts transferred, that, is, the face value less the amount of the reserve for bad debts. But if the Commissioner prevails, the transferee corporation will obtain a basis in the transferred receivables equal to their face value and be permitted to establish its own reserve for bad debts and, thus, obtain a deduction. This deduction by the corporation would have no relationship whatsoever to any income generated by the corporation in the first year and would, thus, greatly distort the corporation's income.<sup>19</sup>

The purpose of the reserve method was to permit the taxpayer to match the expenses against the corresponding income, yet the application of Revenue Ruling 62-128 would disregard this purpose and the economic realities of the reserve method for deducting bad debts.

The Government's position would force reserve method taxpayers to perform artificial pre-incorporation tax planning by withholding from the transfer to controlled corporations, the accounts receivable. Having retained the accounts receivable, they would be free from the Commissioner's attack. These receivables, however, are rightfully and logically part of the transferred business. As an alternative to this method of avoiding the Commissioner's position, the taxpayer could make an outright sale of the

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<sup>19</sup> See the discussion of this point by Arent, *Reallocation of Income and Expenses in Connection with Formation and Liquidation of Corporations*, 40 Taxes, December, 1962 p. 998, wherein Mr. Arent says: "The net effect of the ruling is to shift the deduction representing the risk of noncollection from the transferor to the corporation, even though it is the transferor who pays the tax on the accrued income. The corporation can collect the accounts tax-free since it acquired a substituted basis in the accounts equal to their base amount. Thus, Revenue Ruling 62-128 results in allocating to one entity an item of income and to another entity a direct expense of earning that income, a distortion of net income contrary to the purpose of the reserve method of accounting for bad debts."

accounts receivable prior to incorporation at net value to a third party, thereby avoiding any recognition of income upon the transfer of the other assets and the cash funds to the controlled corporation. In any event, the Commissioner's position would most certainly have the effect of taking a simple transaction, and what is merely a change in the form of a business, and transforming it into a highly technical and tax generating transaction, which was not intended by Congress.<sup>20</sup>

II. SINCE THE AMOUNT IN A RESERVE FOR BAD DEBTS IS NOT TAKEN INTO INCOME BY THE TRANSFEROR IN A CORPORATE REORGANIZATION, THE SAME RULE SHOULD APPLY TO A TRANSFER UNDER SECTION 351.

If a corporation using the accrual method of accounting and the reserve method for bad debts transfers its business, including its receivables, to another corporation in a reorganization as defined in Section 368, the Commissioner would not seek to have the transferor recover into its income the amount of the reserve for bad debts. The transferor corporation does not take the reserve into income, and the transferee corporation will merely set up the reserve on its books without taking a current deduction for the reserve. Yet, if the need for the reserve would cease under a Section 351 transaction, why would it not cease under a reorganization type of transaction?

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<sup>20</sup> This would put back into the scheme of our revenue laws the exact problems which the Senate Finance Committee alluded to in their discussion of this tax-free exchange: "The preceding amendments, if adopted, will, by removing a source of grave uncertainty and by eliminating many technical constructions which are economically unsound, not only permit business to go forward with readjustments required by existing conditions, but also will considerably increase the revenue by preventing taxpayers from taking colorable losses in wash sales and other fictitious exchanges. . . ." S.Rep. 275, 67th Cong. 1st Sess. 10 (1921).

It is readily apparent that the Section 351 corporate organization and the reorganization are quite similar in theory and in purpose. Under Section 362, the basis of property received by the acquiring corporation is the same under Section 351 as it is under a reorganization, namely, its basis in the hands of the transferor.<sup>21</sup> Of course, the basis can be increased by any gain recognized to the transferor. However, the Commissioner in the instant case would even seek to classify the income to the taxpayers, if the Commissioner be successful, not as a "gain" to increase basis, but as "income" having no effect on basis, for no "gain" could be recognized under Section 351.

As this Court has pointed out, "The close relationship between Section 112 (b) (5) [351] and the 'reorganization' provision is further evidenced by the fact that they overlap to a degree." *Helvering v. Cement Investors, Inc.*, 316 U.S. 527, 534. Both Section 351 and the reorganization provisions came into the law in the 1921 Revenue Act.

The District Court in *Home Savings & Loan Association v. United States*, 223 F. Supp. 134, 136 (D.C. Cal. 1963), correctly distinguished the theory behind a merger from that involved in a complete liquidation of a business. The court therein quoted with approval the language of the Court of Claims in *Citizens Federal Savings & Loan Association of Cleveland v. United States*, 290 F.2d 932 (Ct. Cl. 1961), distinguishing between a complete liquidation and a reorganization:

Further, the plaintiff argues for non-recognition [pursuant to Sec. 337] by pointing out that under sections 332(a) and 354(a)(1) of the 1954 Code no gain is recognized on the liquidation of subsidiaries or on stock exchanges in corporate reorganizations. The short an-

<sup>21</sup> §362 is set out in full at p. — in the Appendix.

swer to this, we think, is to emphasize *the clear distinction between a complete liquidation* [pursuant to Sec. 337] on the one hand and *liquidation into a parent corporation* and reorganization of a corporation's capital structure on the other. In the latter situations [sic] *the holder of the asset continues in existence, although in an altered form, and continues to experience the risk of bad debt loss.* Thus, unlike the former situation where the corporation goes out of existence, the reserve does not lose its reason for existence and there is no reason not to accord non-recognition. [Emphasis supplied]

Although this was dictum by the Court of Claims, since they were considering the complete liquidation of a corporation and held that the reserve should be recovered in the income, it does recognize that the holder of the receivables in a reorganization continues in existence in merely an altered form, and "continues to experience the risk of bad debt loss." This should be the same philosophy which applies to the Section 351 transfers where there has been merely a change in form and the controlling stockholder continues to experience the risk of bad debt loss in his corporation.

In *Calavo, Inc. v. Commissioner*, 304 F.2d 650 (9th Cir. 1963), which also involved a Section 332 merger, the Commissioner initially sought to have the amount of the reserve included in the final return of the transferor. But before the Tax Court, he conceded that this was error and that the bad debt reserve was not to be restored to the income of Calavo, Inc., the transferor corporation.<sup>22</sup>

<sup>22</sup> The Tax Court, in the *Estate of Heinz Schmidt*, 42 T.C. 1130, 1136 fn. 7, stated: "The dictum in the *Citizens Federal* case was followed in *Home Savings & Loan Association v. United States*, 223 F.Supp. 134 (D.C. Cal.), and the reason for the Government's failure to pursue an appeal therein has not been disclosed. Similarly, there has

The Tax Court was the first court to consider the problem of the reserve for bad debts in connection with a transfer under Section 351 solely in exchange for stock and securities. *Estate of Heinz Schmidt*, 42 T.C. 1130 (1964), rev'd. 355 F.2d 111 (9th Cir. 1966). The taxpayer, before the Tax Court, had urged that the reserve not be taken into his income in the year of incorporation. The corporation to which the transfer had been made had established a reserve in a like amount, without taking any deduction against its income for the reserve. The taxpayer therein urged, as we similarly urge here, that since the reserve is reasonable, the projected amount of bad accounts will ultimately materialize. The balance in the reserve would be absorbed by the accounts actually charged off by the corporation. If a reserve be incorrect, at the time all of the receivables are collected in, any remaining amount would then be included in the income of the corporation, having been recovered. Judge Raum, in expressing the opinion of the Tax Court, said: "Such result would appear to be desirable, though we are dealing with a statute characterized by a high degree of specificity, and we must take it as we find it." (p. 1136). The Tax Court felt that without a carryover provision specifically set out in the statute they could not reach this desirable result.<sup>23</sup>

In the more recent Tax Court case of *Max Schuster*, 50 T.C. 98 (1968), the court again decided the identical issue before this Court adversely to the taxpayer, relying on the

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been no explanation of the Government's position in *Calavo, Inc. v. Commissioner*, 304 F.2d 650, 652 (C.A. 9), reversing on other grounds a memorandum opinion of this Court."

<sup>23</sup> The Tax Court relied on Rev. Ruling 62-128 and its decision in *West Seattle National Bank of Seattle*, 33 T.C. 341, aff'd. 288 F.2d 47 (9th Cir. 1961), a case dealing with a 337 liquidation. The 9th Circuit effectively distinguished the *West Seattle* case decided by them in their reversal of the *Estate of Schmidt*, 355 F.2d 111, 114 (1966).

same authorities as it had cited in the *Schmidt* case. Judge Raum, writing for the Tax Court, again stated: "The Code is a highly complex instrument, and it would be inappropriate, in order to reach a seemingly equitable result, to proceed upon theories that depart from an established course of decision or that do violence to the statute . . . ." (p. 102).

[Emphasis Supplied]

We would all apparently agree that a rule which would provide no income at the time of incorporation and allowed the reserve to be carried over to the corporation would be the most desirable. We disagree, of course, as to whether it can be reached.<sup>24</sup> We maintain that the lack of specific statutory direction for the carry-over does not obviate the intent, purpose and scope of Section 351.

The logical answer, of course, is that the reserve would be carried over and established by the corporation without the corporation taking a new deduction. This is exactly what took place in the taxpayers' case, in the *Schmidt* case, in the *Schuster* case, and in the other recently reported cases concerning a 351 transaction.<sup>25</sup> In fact, no case can be found which indicates that any corporation in a 351 transaction involving a reserve for bad debts has done other than to merely carry the reserve over without taking or attempting to take any new deduction for the reserve.

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<sup>24</sup> The Fifth Circuit in the decision upon review may have indicated they do not agree that this would be an equitable result. The Court, in their next to the last paragraph in the opinion (A. 15) seems to emphasize the difference in rates which would exist between individual transferors and corporations. Needless to say, this would be a tenuous basis for deciding the correct rule of law. The tax brackets of transferors and transferees may be the same or more or less in reorganizations and in Section 351 transfers.

<sup>25</sup> *Rowe, et al v. United States*, 69-1 U.S.T.C. ¶9162 (D.C. Ky.); *Hutton v. Commissioner*, 53 T.C.—No. 6 (1969); and *Scofield v. United States*, 69-1 U.S.T.C. ¶9386 (D.C. Cal.).

The Commissioner should not contend that the presence of Section 381 in the Internal Revenue Code should distinguish the reorganization situation from the 351 situation. Section 381 was originally enacted in the 1954 Code. (68 Stat. 124.) The only portion of Section 381 which could be pertinent generally requires the acquiring corporation to use the method of accounting used by the transferor corporation.<sup>26</sup>

The Commissioner would seem to have ample authority to require the corporation in a Section 351 transfer to continue the reserve method if that be the key to the Commissioner's apparent dilemma in this situation. Treasury Regulation, Section 1.166-1(b)(1) provides:

(a) A taxpayer filing a return of income for the first taxable year for which he is entitled to a bad debt deduction may select either of the two methods prescribed by paragraph (a) of this section for treating bad debts [either a deduction when the debt becomes worthless or a deduction for a reasonable addition to a reserve] *but such selection is subject to the approval of the District Director upon examination of the return.* [Emphasis supplied]

This section 381 was not relied on in *Home Savings & Loan Association*, 223 F.Supp. 134 (D.C. Cal. 1963), dealing with the merger of the subsidiary into the parent corporation or in the dictum expressed by the Court of Claims in *Citizens Federal Savings & Loan Association of Cleveland*, 290 F.2d 932 (Ct.Cl. 1961). In addition, Treasury Regulation Section 1.381(c)(4)-1 was finally adopted in 1964, subsequent to these decisions.

While Congress, in Section 381, may not have specifically provided for the carry-over of bad debt reserves in the

<sup>26</sup> Section 381(c)(4) is set out in the Appendix to this brief at p. 40.

case of Section 351 transactions, this does not mean that Congress sought to prevent a carry-over of the reserve in a §351 transaction. On the contrary, the Congressional history behind §381; and prior judicial authority, lead to the opposite conclusion.

The Senate Committee Reports contain the following statement:

"Present practice rests on court-made law which is uncertain and frequently contradictory. Your committee agrees that whether or not the items carryover should be based upon economic realities rather than upon such artificialities as the legal form of the reorganization." S.Rep. No. 1622, 83rd Cong. 2d Sess. 52 (1954).

There were no uncertainties in a Section 351 transfer as evidenced by the complete lack of any cases or revenue rulings on the question presented to this court prior to Revenue Ruling 62-128, 1962-2 C.B. 139 (1962) and *Estate of Schmidt*, 42 T.C. 1130, rev'd. 355 F.2d 111 (9th Cir. 1966).

Furthermore, in enacting §381 in the 1954 Code, Congress made it quite clear that §381 dealt only with certain corporate readjustments in the carry-over of specific attributes enumerated therein and that transactions and attributes outside the narrow confines of §381 were not to be affected by the enactment of §381. The following is a statement from the Committee Reports:

Subsection (c) of this section contains 18 paragraphs, each of which specifies an item or tax attribute of distributor or transferor corporation which is to be taken into account by the acquiring corporation as of the close of the date of distribution or transfer in the manner and to the extent provided with respect to such item. *This section is not intended to affect the carry-*

*over treatment of items or tax attributes not specified in the section or the carry-over treatment of items or tax attributes in corporate transactions not described in subsection (a). No inference is to be drawn from the enactment of this section whether any item or tax attribute may be utilized by a successor or a predecessor corporation under existing law. (S. Rep. No. 1622, 83rd Cong. 2nd Sess. 275 (1954).) [Emphasis supplied.]*

Even the Commissioner's own regulation, §1.381(a)-1 (b)(3) provides that in situations where §381 does not apply, no inference is to be drawn from §381 as to whether any item or tax attribute is to be carried over.

Prior to the enactment of §381, and without any specific statutory authority, the courts have permitted the carry-over of certain tax items. In *Helvering v. Metropolitan Edison Co.*, 306 U.S. 522 (1939), and in *Newmarket Manufacturing Co. v. United States*, 233 F.2d 492 (1st Cir. 1956), it was held that in a merger the transferee corporation could carry over the net operating loss of the predecessor corporation.<sup>27</sup> Judge Simpson, in his dissent, in *Max Schuster*, 50 T.C. 98, 103 (1968) considered that the lack of specific statutory authority should not preclude the court from allowing a carry-over of the bad debt reserve because of the judicial history and the theory behind Section 381. This would be the result we would urge the Court to follow.<sup>28</sup>

<sup>27</sup> See also *Commissioner v. Sansome*, 60 F.2d 931 (2nd Cir. 1932), which involved the carry-over of a corporation's earnings and profits.

<sup>28</sup> Judge Simpson stated, in part:

"The majority considers that the lack of a specific statutory authorization precludes us from allowing a carryover of the bad debt reserve in a §351 transfer. However, without specific statutory authority, the carryover of tax attributes from one legal person to another in some cases was allowed prior to the enactment of §381. *Helvering v. Metropolitan Edison Co.*, 306 U.S. 522 [22 AFTR 307]

The Commissioner has provided in his Treasury Regulations under Section 381 that an acquiring corporation, in a transaction covered by Section 381, shall take into account the dollar balances of accounts which represent reserves for prior years.<sup>29</sup> This would provide for the carry-over in the Commissioner's view of the bad debt reserve. This Section construes Section 381(c)(4) of the Internal Revenue Code where Congress provided for the method of accounting to be carried over. The legislative history does not define "method of accounting" to include the reserve method of deducting bad debts. The Commissioner, in Treasury Regulation Section 1.446-1(a)(1) dealing with methods of accounting, does not mention the reserve method as being a "method of accounting." In addition, the statutory reference to the carry-over method does not deny a new deduction. It can only be concluded that the Commissioner, in promul-

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(1939); *Commissioner v. Sansome*, 60 F.2d 931 [11 AFTR 857] (C.A. 2, 1932). Moreover, although §381 contains extensive rules regarding carryovers in some transactions, Congress made clear that §381 was not to be exclusive. S. Rep. No. 1622, 83rd Cong., 2d Sess., pp. 276-277 (1954), and H. Rept. No. 1337, 83d Cong., 2d Sess., p. A135 (1954), to accompany H.R. 8300 (Pub. L. 591). See also §1.381(a)-1(b)(3), Income Tax Regs. In addition, without specific statutory authorization, the regulations provide that the transfer of an installment obligation in a transaction under §351 is not a disposition of the obligation for purposes of §453(d). Sec. 1.453-9(c)(2).

To avoid distorting the income of the business and to carry out the purpose of §351, I would hold that the transferor's unused bad debt reserve is carried over to the transferee corporation. As a result, the transferor would not be taxed on the unused reserve, and the transferee would not be allowed a deduction for building up a reserve. The transferee would stand in the shoes of the transferor so that the corporation would be required to continue to use the reserve method for treating bad debts, unless it secured the approval of the Commissioner to change such method."

<sup>29</sup> Treas. Reg. §1.381(c)(4)-1(a)(1)(ii).

gating his regulations, felt that the reserve for bad debts should be carried over and not restored to income where there was a mere change in the form of a business, such as in the liquidation of a subsidiary, or a reorganization. These transactions are very similar to Section 351 exchanges, in that there is simply a change in the *form* of doing business.

The Commissioner should not be apprehensive about a corporation trying to take advantage of the Section 351 transfer involving a reserve for bad debts for the Commissioner has not only his regulations previously referred to under Section 166, but also has other weapons in his armory. If the corporation were to attempt to select a direct charge-off method and establish a basis for the receivables at their face instead of net value, the Commissioner could come forward with Section 446 asserting that either the new corporation's method does not clearly reflect income, or that the old partnership or proprietorship method did not clearly reflect income. See *Commissioner v. Kuckenberg*, 309 F.2d 202 (9th Cir. 1960); cert. den'd. 373 U.S. 909 (1963) (involving the reallocation of income to a corporation). Or the Commissioner could utilize Section 482 providing for allocation of income and expenses among two controlled businesses in order to prevent evasion of taxes or clearly reflect the income of any such businesses. See *Rooney v. United States*, 305 F.2d 681 (9th Cir. 1962) (reallocation to corporation of expenses incurred by an individual prior to a Section 351 transfer).<sup>30</sup>

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<sup>30</sup> See also *Palmer v. Commissioner*, 267 F.2d 434 (9th Cir. 1959) (Earnings adjusted between corporation and partnership based on assignment of income); *United States v. Lynch*, 192 F.2d 718 (9th Cir. 1951); cert. den. 343 U.S. 934 (income deemed earned by the corporation and the power of Commissioner to require method of accounting which would clearly reflect income, §446); *National Securities Corporation v. Commissioner*, 137 F.2d 600 (3rd Cir. 1942).

Possibly, the simplest approach is to recognize that the reserve for bad debts reduces the basis for the receivables to the partnership and, thus, to the transferee corporation much in the same fashion that a reserve for depreciation functions. Depreciation is regarded as an adjustment to basis under Section 1016(a)(2) and the bad debt reserve additions could be regarded as similar adjustments to basis under Section 1016(a)(1). The Commissioner does not contend that depreciation adjustments give rise to taxable income upon the creation of a corporation under Section 351. This is true even under the stringent requirements of the relatively new depreciation recapture rules of Section 1245(b)(3) and 1250(b)(3). Section 1016(a)(1) requires adjustment for "expenditures, receipts, losses or other items properly chargeable to capital account." Section 1011, which determines bases of assets, provides for adjustments as provided in Section 1016. The Commissioner would contend that the additions to reserves are not adjustments, but would agree that direct charge-offs under the alternate method provided for bad debts would be. It would seem only proper, however, that the taxpayer who elects the reserve method of accounting for bad debts should not be treated differently from one who uses the direct charge-off method, and that both should adjust the basis of the accounts receivable when either the debt is charged off or the addition to the reserve is made. Having an adjusted basis, the receivables would then go over to the corporation, at their adjusted basis, and there would be no possible way for the corporation to secure any second deduction since it would be

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(allocation of loss between two businesses based on power given Commissioner under predecessor of §482 and §45, Rev. Act 1936); *Central Cuba Sugar Co. v. Commissioner*, 198 F.2d 214 (2nd Cir. 1952), cert. den'd. 344 U.S. 874 (1952) (income required to be recognized by corporation in order to clearly reflect income).

dealing with receivables which had a basis equal to the net value to the transferor. Section 362(a) requires both in a reorganization and a 351 transfer, that the controlled corporations carry over and retain the bases for transferred property in the hands of the transferor.

Congress has treated Section 351 transfers and reorganizations in a similar fashion from their inception in 1921 to the present time.<sup>31</sup> Section 381 was not deemed to be exclusive, and was put in the Code, frankly, when no one was aware that a problem existed in this area under Section 351. Since these two reorganizations of businesses are so similar in theory and in concept, there should be no disparity in the treatment by the Commissioner of the reserve for bad debts of a transferor who participates in either one or the other form of business adjustments.

### III. THE AMOUNT IN THE RESERVE FOR BAD DEBTS SHOULD BE RESTORED TO TAXABLE INCOME, PROVIDED ADDITIONS THERETO HAVE RESULTED IN TAX BENEFITS, WHEN THERE IS A RECOVERY.

The Commissioner is incorrect in his statement in Revenue Ruling 62-128, that the reserve represents ordinary income when the need for the reserve ceases. The cases relied on by the Commissioner in propounding the rule do not go that far.<sup>32</sup> We have never agreed that the presence of need is the determining factor as indicated by the court

<sup>31</sup> See similar treatment under the recapture rules of Sections 47(b), 1245(b)(3), and 1250(d)(3) of the Code.

<sup>32</sup> See a discussion of this point in *Estate of Schmidt v. Commissioner*, 355 F.2d 111, 113 (1966). In Footnote 7, the Ninth Circuit states:

"In *Geyer, Cornell & Newell, Inc.*, 1946, 6 T.C. 96, the amount of the reserve was actually collected. This is equally true of *West Seattle Nat'l. Bank*, *supra*, and of the other cases upon which the Commissioner principally relies: *S. Rossin & Sons, Inc. v. Commissioner*,

below, but have continued to insist throughout this litigation that there must be recovery before the reserve is taken into income. The Fifth Circuit stated that this lack of need generally occurred upon final liquidation or upon sale of the assets in a manner that demonstrates that they are worth face value. (A. 15). We submit it is not the lack of need which occurs at this point, but a recovery and that this is the basis for taking the reserve into income.

The Commissioner in Revenue Ruling 62-128 cited as authority *Geyer, Cornell and Newell, Inc. v. Commissioner*, 6 T.C. 96 (1946). In this case, the Commissioner had urged that a reserve for bad debts became taxable income to a corporation when it transferred its assets to another corporation in exchange for certain stock. The taxpayer therein urged the reserve should have been picked up in an earlier year at a time all of his receivables had been paid in full. The Court held in favor of the taxpayer. The Commissioner also cited *C. Standlee Martin, Inc. v. Riddell*, 56-2 U.S.T.C. ¶9989, 51 AFTR 1376 (D.C. Cal. 1956). This was a District Court case involving a memorandum opinion considering the effects of a complete liquidation of a corpo-

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2 Cir., 1940, 113 F.2d 652, 654; *Citizens Fed. Sav. & Loan Co. v. United States*, 1961, 290 F.2d 932, 936, 154 Cl. Cl. 305; *Arcadia Sav. & Loan Ass'n. v. Commissioner*, 9 Cir., 1962, 300 F.2d 247. The lack of 'need' for the reserve arose from collection (or sale) of the receivables. And, as is illustrated by the foregoing cases, it is generally only to the extent that what is collected represents the reserve, or a part of it, that income is said to be realized. There may be cases, such as a change in accounting methods, where the 'realization' is technical rather than actual (see *Arcadia*, supra, at p. 250), but we think that this case is not one of them."

ration. The Commissioner also cited as authority his Revenue Ruling 57-482, 1957-2 C. B. 49.<sup>33</sup>

That there must be a recovery before income results was the basis of the Ninth Circuit's opinion in the *Schmidt* case, reversing the Tax Court. 355 F.2d 111 (1966).

Since the reserve was deemed to be reasonable, the value of the stock received upon the transfer was equal to the net value of the receivables and, therefore, there was not any "recovery." The court said: "We think that, whether the sale be for cash or stock, no income is received, unless the consideration received exceeds the net amount of the receivables. . . . We think that where accounts receivable are sold for cash for less than face value, the difference being the amount of the reserve, the taxpayer does not then 'realize a loss.' He 'realized' the loss for tax purposes, when he set up the reserve, and cannot have it twice. The price received merely demonstrates that the estimate of the loss was correct." (p. 114)

The Commissioner seemed to recognize the need for a recovery in Revenue Ruling 57-482, 1957-2 C.B. 49, wherein it was held that the bad debt reserve must be restored to

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<sup>33</sup> Rev. Rul. 57-482 is set forth in full in Appendix at p 49. It is interesting to note the Revenue Ruling cites as authority only the *Geyer* case, *supra*. The Tax Court in §337 liquidations has required the reserve to be recovered by the liquidating corporation. *Byrd Management, Inc.*, 48 T.C. 586 (1967); *J. E. Hawes Corp.*, 44 T.C. 705 (1965). However, in each of these cases, the evidence does not show the receivables to be worth less than face value. Of course, the statutory purpose of §337 is quite different from §351. See S. Rep. 1622, 83rd Cong. 2d Sess., 258 (1954). This provision was introduced in the 1954 Code to avoid taxation on both the corporation and the stockholder on the same transaction, and eliminate the problem of whether a sale had been made by the corporation before liquidation or by the stockholders after liquidation.

income in a Section 337 liquidation, where there has been a sale of accounts receivable for their "face value."

In Revenue Ruling 62-128, the Commissioner further provided that additions to the reserve for bad debts which had not resulted in tax benefits would not have to be included in gross income. This is essentially the same rule as promulgated by Section 111 pursuant to which a taxpayer using the direct charge-off method, must, upon recovery of a debt, restore the amount of the debt to income to the extent of the tax benefits afforded him in prior years by the charge-off.<sup>34</sup> The Commissioner provides very comprehensive regulations under this section, and sets forth therein the following definition of the term "recovery": "Recoveries result from the receipt of amounts in respect of the previously deducted or credited Section 111 items, such as from the collection or sale of a bad debt, refund or credit of tax paid, or cancellation of taxes accrued. . . ."<sup>35</sup>

While the Commissioner apparently adheres to the theory that the tax benefit rule applies in Section 351 situations as illustrated by Revenue Ruling 62-128, he fails to correctly follow this theory to its conclusion. Although Section 111 is not applicable to the taxpayer on the reserve method, the basic equitable philosophy expressed therein should be judicially impressed on the reserve for bad debts.<sup>36</sup> Upon the transfer of notes and accounts receivables to a corporation in exchange for stock and securities representing the net value of the receivables, there is no "recovery" of the reserve for bad debts. In a Section 351 transaction, there is no collection or recovery of a bad debt, but merely an adjustment in the form in which the business is carried on.

<sup>34</sup> The pertinent portions of Section 111 are set forth in Appendix at p. —.

<sup>35</sup> Treas. Reg. §1.111-1(a)(2).

<sup>36</sup> H. Rep. 2333, 77th Cong., 2nd Sess. 69-71 (1942).

**CONCLUSION**

**The judgment of the Court of Appeals should be reversed  
and the decision of the District Court ordered affirmed.**

**Respectfully submitted,**

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**HAROLD I. APOLINSKY**

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**JOSEPH S. BLUESTEIN**  
*Attorneys for Petitioners*

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**ALEX W. NEWTON**  
*Of Council for Petitioners*

**DATED: FEBRUARY 1970.**

## APPENDIX

### Statutes, Regulations, and Ruling Involved Internal Revenue Code of 1954:

#### SEC. 111, RECOVERY OF BAD DEBTS, PRIOR TAXES, AND DELINQUENCY AMOUNTS.

(a) General Rule.—Gross income does not include income attributable to the recovery during the taxable year of a bad debt, prior tax, or delinquency amount, to the extent of the amount of the recovery exclusion with respect to such debt, tax, or amount.

(b) Definitions.—For purposes of subsection (a)—

(1) Bad Debt.—The term “bad debt” means a debt on account of the worthlessness or partial worthlessness of which a deduction was allowed for a prior taxable year.

(2) Prior Tax.—The term “prior tax” means a tax on account of which a deduction or credit was allowed for a prior taxable year.

(3) Delinquency Amount.—The term “delinquency amount” means an amount paid or accrued on account of which a deduction or credit was allowed for a prior taxable year and which is attributable to failure to file return with respect to a tax, or pay a tax, within the time required by the law under which the tax is imposed, or to failure to file return with respect to a tax or pay a tax.

(4) Recovery Exclusion.—The term “recovery exclusion,” with respect to a bad debt, prior tax, or delinquency amount, means the amount, determined in accordance with regulations prescribed by the Secretary or his delegate, of the deductions or credits allowed, on account of such bad debt, prior tax, or delinquency amount, which did not result in a reduction of the taxpayer's tax under this subtitle (not including the accumulated earnings tax imposed by

section 531 or the tax on personal holding companies imposed by section 541) or corresponding provisions of prior income tax laws (other than subchapter E of chapter 2 of the Internal Revenue Code of 1939, relating to World War II excess profits tax), reduced by the amount excludable in previous taxable years with respect to such debt, tax, or amount under this section.

\* \* \* \*

[26 U.S.C. Sec. 111.]

SEC. 166. BAD DEBTS.

(a) General Rule.—

(1) Wholly Worthless Debts.—There shall be allowed as a deduction any debt which becomes worthless within the taxable year.

(2) Partially Worthless Debts.—When satisfied that a debt is recoverable only in part, the Secretary or his delegate may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction.

(b) Amount of Deduction.—For purposes of subsection (a), the basis for determining the amount of the deduction for any bad debt shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

(c) Reserve for Bad Debts.—In lieu of any deduction under subsection (a), there shall be allowed (in the discretion of the Secretary or his delegate) a deduction for a reasonable addition to a reserve for bad debts.

\* \* \* \*

[26 U.S.C. Sec. 166.]

SEC. 337. GAIN OR LOSS ON SALES OR EXCHANGES IN CONNECTION WITH CERTAIN LIQUIDATIONS.

(a) General Rule.—If—

(1) a corporation adopts a plan of complete liquidation on or after June 22, 1954, and

(2) within the 12-month period beginning on the date of the adoption of such plan, all of the assets of the corporation are distributed in complete liquidation, less assets retained to meet claims, then no gain or loss shall be recognized to such corporation from the sale or exchange by it of property within such 12-month period.

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[26 U.S.C. Sec. 337.]

**SEC. 351. TRANSFER TO CORPORATION CONTROLLED BY TRANSFEROR.**

(a) General Rule.—No gain or loss shall be recognized if property is transferred to a corporation (including, in the case of transfers made on or before June 30, 1967, an investment company) by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation. For purposes of this section, stock or securities issued for services shall not be considered as issued in return for property.

(b) Receipt of Property.—If subsection (a) would apply to an exchange but for the fact that there is received, in addition to the stock or securities permitted to be received under subsection (a), other property or money, then—

(1) gain (if any) to such recipient shall be recognized, but not in excess of—

(A) the amount of money received, plus

(B) the fair market value of such other property received; and

(2) no loss to such recipient shall be recognized.

(c) Special Rule.—In determining control, for purposes of this section, the fact that any corporate transferor distributes part or all of the stock which it receives in the ex-

change to its shareholders shall not be taken into account.

\* \* \* \*

[26 U.S.C. Sec. 351.]

#### SEC. 362. BASIS TO CORPORATIONS

(a) Property Acquired by Issuance of Stock or as Paid-In Surplus.—If property was acquired on or after June 22, 1954, by a corporation—

(1) in connection with a transaction to which section 351 (relating to transfer of property to corporation controlled by transferor) applies, or

(2) as paid-in surplus or as a contribution to capital, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer.

(b) Transfers to Corporations.—If property was acquired by a corporation in connection with a reorganization to which this part applies, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer. This subsection shall not apply if the property acquired consists of stock or securities in a corporation a party to the reorganization, unless acquired by the exchange of stock or securities of the transferee (or of a corporation which is in control of the transferee) as the consideration in whole or in part for the transfer.

\* \* \* \*

[26 U.S.C. Sec. 362.]

#### SEC. 381. CARRYOVERS IN CERTAIN CORPORATE ACQUISITIONS

(a) General Rule.—In the case of the acquisition of assets of a corporation by another corporation—

(1) in a distribution to such other corporation to which section 332 (relating to liquidations of subsidiaries) applies, except in a case in which the basis of the assets distributed is determined under section 334(b)(2); or

(2) in a transfer to which section 361 (relating to nonrecognition of gain or loss to corporations) applies, but only if the transfer is in connection with a reorganization described in subparagraph (A), (C), (D) (but only if the requirements of subparagraph (A) and (B) of section 354(b)(1) are met), or (F) of section 368(a)(1),

the acquiring corporation shall succeed to and take into account, as of the close of the day of distribution or transfer, the items described in subsection (c) of the distributor or transferor corporation, subject to the conditions and limitations specified in subsections (b) and (c).

\* \* \* \*

(c) Items of the Distributor or Transferor Corporation.—The items referred to in subsection (a) are:

\* \* \* \*

(4) Method of Accounting.—The acquiring corporation shall use the method of accounting used by the distributor or transferor corporation on the date of distribution or transfer unless different methods were used by several distributor or transferor corporations or by a distributor or transferor corporation and the acquiring corporation. If different methods were used, the acquiring corporation shall use the method or combination of methods of computing taxable income adopted pursuant to regulations prescribed by the Secretary or his delegate.

\* \* \* \*

[26 U.S.C. Sec. 381.]

#### SEC. 446. GENERAL RULE FOR METHODS OF ACCOUNTING.

(a) General Rule.—Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

(b) Exceptions.—If no method of accounting has been regularly used by the taxpayer, or if the method used does

not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income.

[Sec. 446 (c)]

(c) **Permissible Methods.**—Subject to the provisions of subsections (a) and (b), a taxpayer may compute taxable income under any of the following methods of accounting—

- (1) the cash receipts and disbursements method;
- (2) an accrual method;
- (3) any other method permitted by this chapter; or
- (4) any combination of the foregoing methods permitted under regulations prescribed by the Secretary or his delegate.

(d) **Taxpayer Engaged in More Than One Business.**—A taxpayer engaged in more than one trade or business may, in computing taxable income, use a different method of accounting for each trade or business.

[Sec. 446 (e)]

(e) **Requirement Respecting Change of Accounting Method.**—Except as otherwise expressly provided in this chapter, a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Secretary or his delegate.

[26 U.S.C. Sec. 446.]

**SEC. 482. ALLOCATION OF INCOME AND DEDUCTIONS AMONG TAXPAYERS.**

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or

allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

[26 U.S.C. Sec. 482.]

**SEC. 1016. ADJUSTMENTS TO BASIS.**

(a) General Rule.—Proper adjustment in respect of the property shall in all cases be made—

(1) for expenditures, receipts, losses, or other items, properly chargeable to capital account, but no such adjustment shall be made—

(A) for taxes or other carrying charges described in section 266, or

(B) for expenditures described in section 173 (relating to circulation expenditures), for which deductions have been taken by the taxpayer in determining taxable income for the taxable year or prior taxable years;

(2) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent of the amount—

(A) allowed as deductions in computing taxable income under this subtitle or prior income tax laws, and

(B) resulting (by reason of the deductions so allowed) in a reduction for any taxable year of the taxpayer's taxes under this subtitle (other than chapter 2, relating to tax on self-employment income), or prior income, war-profits, or excess-profits tax laws. . . .

\* \* \* \*

[26 U.S.C. Sec. 1016.]

Revenue Act of 1921:

**SEC. 202. BASIS FOR DETERMINING GAIN OR LOSS.**

\* \* \* \*

(c) For the purposes of this title, on an exchange of property, real, personal or mixed, for any other such property, no gain or loss shall be recognized unless the property received in exchange has a readily realizable market value; but even if the property received in exchange has a readily realizable market value, no gain or loss shall be recognized—

(1) When any such property held for productive use in trade or business (not including stock-in-trade or other property held primarily for sale), is exchanged for property of a like kind or use;

(2) When in the reorganization of one or more corporations a person receives in place of any stock or securities owned by him, stock or securities in a corporation a party to or resulting from such reorganization. The word "reorganization," as used in this paragraph, includes a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or of substantially all the properties of another corporation), recapitalization, or mere change in identity, form, or place of organization of a corporation, (however effected); or

(3) When (A) a person transfers any property, real, personal or mixed, to a corporation, and immediately after the transfer is in control of such corporation, or (B) two or more persons transfer any such property to a corporation, and immediately after the transfer are in control of such corporation, and the amounts of stock, securities, or both, received by such persons are in substantially the same proportion as their interests in the property before such transfer. For the purposes of this paragraph, a person is, or two or more persons are, "in control" of a corporation when owning at least 80 per centum of the voting stock and at least 80 per centum of

the total number of shares of all other classes of stock of the corporation.

**Treasury Regulations (1954 Code):**

**§1.166-1. Bad Debts.—**

(a) Allowance of Deduction.—Section 166 provides that, in computing taxable income under section 63, a deduction shall be allowed in respect of bad debts owed to the taxpayer. For this purpose, bad debts shall, subject to the provisions of section 166 and the regulations thereunder, be taken into account either as—

(1) A deduction in respect of debts which become worthless in whole or in part; or as

(2) A deduction for a reasonable addition to a reserve for bad debts.

(b) Manner of Selecting Method.—(1) A taxpayer filing a return of income for the first taxable year for which he is entitled to a bad debt deduction may select either of the two methods prescribed by paragraph (a) of this section for treating bad debts, but such selection is subject to the approval of the district director upon examination of the return. If the method so selected is approved, it shall be used in returns for all subsequent taxable years unless the Commissioner grants permission to use the other method. A statement of facts substantiating any deduction claimed under section 166 on account of bad debts shall accompany each return of income.

\* \* \* \*

[26 C. F. R. 1.166-1.]

**§1.166-4. Reserve for Bad Debts.—**

(a) Allowance of Deduction.—A taxpayer who has established the reserve method of treating bad debts and has maintained proper reserve accounts for bad debts or who, in accordance with paragraph (b) of §1.166-1, adopts the reserve method of treating bad debts may deduct from gross

income a reasonable addition to a reserve for bad debts in lieu of deducting specific bad debt items.

(b) Reasonableness of Addition to Reserve.—

(1) Relevant factors. What constitutes a reasonable addition to a reserve for bad debts shall be determined in the light of the facts existing at the close of the taxable year of the proposed addition. The reasonableness of the addition will vary as between classes of business and with conditions of business prosperity. It will depend primarily upon the total amount of debts outstanding as of the close of the taxable year, including those arising currently as well as those arising in prior taxable years, and the total amount of the existing reserve.

(2) Correction of Errors in Prior Estimates. In the event that subsequent realizations upon outstanding debts prove to be more or less than estimated at the time of the creation of the existing reserve, the amount of the excess or inadequacy in the existing reserve shall be reflected in the determination of the reasonable addition necessary in the current taxable year.

\* \* \* \*

[26 C.F.R. 1.166-4.]

§1.351-1. Transfer to Corporation Controlled by Transferor.—

(a) (1) Section 351(a) provides, in general, for the non-recognition of gain or loss upon the transfer by one or more persons of property to a corporation solely in exchange for stock or securities in such corporation if, immediately after the exchange, such person or persons are in control of the corporation to which the property was transferred. As used in section 351, the phrase "one or more persons" includes individuals, trusts, estates, partnerships, associations, companies, or corporations (see section 7701(a)(1)). To be in control of the transferee corporation, such person or per-

sons must own immediately after the transfer stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of such corporation (see section 368(c)). In determining control under this section, the fact that any corporate transferor distributes part or all of the stock which it receives in the exchange to its shareholders shall not be taken into account. The phrase "immediately after the exchange" does not necessarily require simultaneous exchanges by two or more persons, but comprehends a situation where the rights of the parties have been previously defined and the execution of the agreement proceeds with an expedition consistent with orderly procedure. For purposes of this section—

(i) stock or securities issued for services rendered or to be rendered to or for the benefit of the issuing corporation will not be treated as having been issued in return for property, and

(ii) stock or securities issued for property which is of relatively small value in comparison to the value of the stock and securities already owned (or to be received for services) by the person who transferred such property, shall not be treated as having been issued in return for property if the primary purpose of the transfer is to qualify under this section the exchanges of property by other persons transferring property.

For the purpose of section 351, stock rights or stock warrants are not included in the term "stock or securities."

\* \* \* \*

[26 C.F.R. 1.351-1.]

§1.362-1. Basis to Corporations.—Section 362 provides, as a general rule, that if property was acquired on or after June 22, 1954, by a corporation in connection with (a) a transaction to which section 351 (relating to transfer of

property to corporation controlled by transferor) applies, (b) as paid-in surplus or as a contribution to capital, or (c) in connection with a reorganization to which Part III, subchapter C, chapter 1 of the Code, applies, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer. Section 362 does not apply if the property acquired consists of stock or securities in a corporation a party to the reorganization, unless acquired by the issuance of stock or securities of the transferee as the consideration in whole or in part for the transfer. (See also §1.362-2.) [Reg. §1.362-1.]

\* \* \* \*

[26 C.F.R. 1.362-1.]

§1.381 (a)—1. Carryovers in Certain Corporate Acquisitions.

\* \* \* \*

§1.381(c)(4)-1. Method of Accounting.—(a) Carry-over Requirement.—(1) General Rule. (i) Section 381(c)(4) provides that, in a transaction to which section 381(a) applies, an acquiring corporation shall use the same method of accounting used by the distributor or transferor corporation on the date of distribution or transfer unless different methods of accounting were used on that date by several distributor or transferor corporations or by a distributor or transferor corporation and the acquiring corporation. If different methods of accounting were used, the acquiring corporation shall use the method or combination of methods of accounting adopted pursuant to this section.

(ii) The acquiring corporation shall take into its accounts the dollar balances of those accounts of the distributor or transferor corporation representing items of income or deduction which, because of its method of accounting, were not required or permitted to be included or de-

ducted by the distributor or transferor corporation in computing taxable income for taxable years ending on or before the date of distribution or transfer. The acquiring corporation shall similarly take into its accounts the dollar balances of those accounts of the distributor or transferor corporation which represent reserves in respect of which the distributor or transferor corporation has taken a deduction for taxable years ending on or before the date of distribution or transfer. Items of income and deduction shall have the same character in the hands of the acquiring corporation as they would have had in the hands of the distributor or transferor corporation or corporations if no distribution or transfer had occurred. This section shall have no application to items of income or deduction, or dollar balances, to the extent they are attributable to assets or liabilities not distributed or transferred, and shall have no application to items the tax treatment of which is specifically provided for in other paragraphs of section 381(c). In the case of an obligation of the distributor or transferor corporation which is assumed by the acquiring corporation and which gives rise to a liability (within the meaning of paragraph (a)(4) of §1.381(c)(16)-1) after the date of distribution or transfer, the deductibility of such an item is determined under this section if it is not deductible under section 381(c)(16) and the regulations thereunder. The amount of the adjustments necessary to reflect a change in accounting method pursuant to this section, the manner in which they are to be taken into account, and the tax attributable thereto shall be determined and computed under section 481 and the regulations thereunder, subject to the rules provided in paragraphs (c) and (d) of this section. Where such change is a change from the accrual to the installment method by a dealer in personal property, section 453(c) and the regulations thereunder apply.

[26 C.F.R. 1.381(c)-4.]

Rev. Rul. 57-482

In accordance with a plan of complete liquidation adopted after June 22, 1954, a corporation sold its assets, including accounts receivable at face value, in a transaction on which no gain or loss is recognized to the corporation under section 337 of the Internal Revenue Code of 1954. However, there remained, on the books of the corporation, a reserve for bad debts which had at all times been reasonable and necessary and which had been accumulated by additions for which the taxpayer derived full tax benefits in prior taxable years. *Held*, the reserve for bad debts constitutes ordinary income to the corporation in its final Federal income tax return, since the need for maintaining the reserve ceased when the taxpayer disposed of the accounts receivable. See *Geyer, Cornell & Newell, Inc. v. Commissioner*, 6 T.C. 96, acquiescence, C.B. 1946-1, 2. The fact that no gain or loss on the sale of the assets was recognized to the corporation pursuant to section 337 of the Code does not have any bearing upon the realization of income by the corporation when the need for maintaining the reserve for bad debts ceased.

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# **In the Supreme Court of the United States**

**OCTOBER TERM, 1969**

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**No. 678**

**JAMES G. NASH, -ET AL., PETITIONERS**

**v.**

**UNITED STATES OF AMERICA**

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**ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF  
APPEALS FOR THE FIFTH CIRCUIT**

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**BRIEF FOR THE UNITED STATES**

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## **OPINIONS BELOW**

The findings of fact and conclusions of law of the district court (R. 12-13)<sup>1</sup> are not officially reported. The opinion of the court of appeals (R. 16-19) is reported at 414 F. 2d 627.

## **JURISDICTION**

The judgments of the court of appeals were entered on July 2, 1969 (R. 20-22). The petition for a writ of certiorari was filed on September 30, 1969, and certiorari was granted on January 12, 1970 (R. 23). The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

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<sup>1</sup> "R." references are to the record appendix.

### QUESTION PRESENTED

Whether a partnership's reserve for bad debts, representing income tax deductions allowed in prior years, should be restored to partnership income under the tax benefit rule upon the transfer of the partnership's accounts receivable to controlled corporations under Section 351 of the Internal Revenue Code.

### STATUTES AND REGULATIONS INVOLVED

- The pertinent provisions of Sections 166, 351 and 362 of the Internal Revenue Code of 1954 and Section 1.166-4 of the Treasury Regulations are set forth in the Appendix, *infra*, pp. 33-36.

### STATEMENT

During 1960, petitioners<sup>2</sup> were members of a partnership operating eight finance organizations in Alabama and two in South Carolina. The partnership reported its income on the accrual method of accounting and used the reserve method of accounting for bad debts permitted by Section 166(c) of the Internal Revenue Code of 1954 and Treasury Regulations, Section 1.166-4. (R. 7.)

Under the reserve method of accounting for bad debts, a taxpayer includes in his income the full face amount of an account receivable upon its creation. He also maintains a reserve account, the balance of which is to be adjusted at the end of each taxable year so that it equals that portion of current accounts re-

<sup>2</sup> In addition to James G. Nash, petitioners are Cecelia Nash, who is a party solely by reason of the filing of a joint return; Birmingham Trust National Bank, as Trustee of the Margaret Nash Trust; and Birmingham Trust National Bank, as Trustee under the James G. Nash, Jr. Trust (R. 15-16).

ceivable which is reasonably estimated to become worthless in subsequent years. Any additions necessary to increase the reserve to its required level are currently deductible. When specific accounts receivable actually become worthless during the year, the reserve account is decreased and no additional bad debt deduction is allowed.

As of May 31, 1960, petitioners' partnership books reflected accounts receivable for the Alabama organizations of \$486,853.69 and a reserve for bad debts of \$73,028.05 (R. 7).<sup>\*</sup>

On June 1, 1960, petitioners formed eight new corporations and transferred the assets of the eight Alabama organizations, including the accounts receivable, to these corporations in exchange for the latter's stock. The transfer was within the terms of Section 351 of the Internal Revenue Code, which provides that no gain or loss shall be recognized if property is transferred to a corporation in exchange for stock if, immediately after the exchange, the transferors possess at least 80 percent control of the corporation. (R. 7.)

Upon examination of the partnership return filed for the fiscal year ended January 31, 1961, the Commissioner determined that the partnership should have included in income the amount of the bad debt reserve (\$73,028.05) applicable to the accounts receivable transferred to the corporations on June 1, 1960, because the partnership no longer had need of

<sup>\*</sup> The exact amounts of the accounts receivable and reserves for bad debts of each of the eight Alabama organizations are set forth in the stipulation of facts (R. 7-11).

the reserve account. This adjustment in the partnership income led to an increase in the distributive shares of petitioners and resulting tax deficiencies for the calendar year 1961. (R. 11.)<sup>4</sup> Petitioners paid the deficiencies and brought suit in the district court after denial of their refund claims (R. 11).

The district court held that the amount of the outstanding reserve for bad debts did not have to be restored to petitioners' income as of the end of the partnership's fiscal year in which the transfer occurred (R. 12-13). On the government's appeal, the Fifth Circuit reversed (R. 16-19).

To resolve a square conflict of decisions between the Fifth and Ninth Circuits on this issue, this Court granted the taxpayers' petition for certiorari on January 12, 1970 (R. 23).

## ARGUMENT

### INTRODUCTION AND SUMMARY

Under the reserve method of accounting for bad debts, a taxpayer is permitted to take a current deduction for the amount of its accounts receivable which it is estimated will become worthless in subsequent taxable years.<sup>5</sup> The problem presented in this case is

<sup>4</sup> The deficiencies determined against petitioners were as follows (R. 11): James G. Nash and Cecelia Nash—\$48,473.14; Birmingham Trust National Bank as Trustee for James G. Nash, Jr.—\$1,042.96; and Birmingham Trust National Bank, as Trustee for Margaret Nash—\$1,041.52.

<sup>5</sup> The reserve method is to be contrasted with the specific charge off method under which a deduction for bad debts is allowed only as and when a specific account becomes worthless. The use of either method is authorized in Section 166 of the Internal Revenue Code.

the proper tax treatment of a bad debt reserve of a partnership when it transfers all of its assets to a corporation in exchange for the latter's stock in a transaction described in Section 351 of the Internal Revenue Code. Because a bad debt reserve represents anticipated future losses that have not in fact been sustained, the possibility exists, if adjustment is not made for the bad debt reserve, that the identical bad debt loss would be allowed twice—once to the partnership when it established the reserve and a second time to the corporation which will actually suffer the bad debt loss on the accounts receivable transferred.

Petitioners recognize the necessity for avoidance of a double deduction of the same bad debt loss (Br. 5-6, 20-31). They can do no less, for decisions of this Court extending over a period of more than four decades—the most recent of which was announced only last Term—make it clear that “the Code should not be interpreted to allow \* \* \* ‘the practical equivalent of double deduction,’ \* \* \* absent a clear declaration of intent by Congress.” *United States v. Skelly Oil Co.*, 394 U.S. 678, 684. See *United States v. Ludey*, 274 U.S. 295, 301; *Burnet v. Aluminum Goods Co.*, 287 U.S. 544, 551; *Ilfeld Co. v. Hernandez*, 292 U.S. 62, 68.<sup>o</sup>

<sup>o</sup>The policy against the allowance of double deductions is reflected in various provisions of the Internal Revenue Code (Sections 164(e), 642(e), 642(g), 1311-1315, 1341(b)(3) and 7852(c)) and the Treasury Regulations (Sections 1.62-1(b), 1.161-1, 1.691(b)-1(b), 1.901-1(b)(2)(h) and 1.1016-6(a)) and has been the basis of decision in numerous lower court cases. See, e.g., *Candy Bros. Mfg. Co. v. Commissioner*, 17 T. C. 298, 304, affirmed, 198 F. 2d 330 (C.A. 8); *Eljer Co. v. Commissioner*,

The dispute between the parties thus is not so much *whether* a double deduction is to be avoided, but *which* of several possible rules should be applied to avoid a double deduction. The Code does not speak explicitly to the point. The position of the Commissioner of Internal Revenue, which was approved by the court below but rejected by the Ninth Circuit in *Estate of Schmidt v. Commissioner*, 355 F.2d 111, is set out in Rev. Rul. 62-128, 1962-2 Cum. Bull. 139. That ruling provides that since the Section 351 transfer makes it clear that the transferor will not suffer the losses represented by the earlier deductions, the balance of the reserve should be restored to income pursuant to the so-called "tax benefit" rule. Under this rule, the recovery of an item—in this case the bad debt reserve—which has produced an income tax benefit in a prior year is to be added to income in the year of recovery. Consistently, the Commissioner would permit the corporation to which the accounts receivable are transferred to take an appropriate bad debt deduction in respect of the receivables transferred.

Petitioners contend, on the other hand, that the tax benefit rule does not apply here because the transferor did not collect the full face amount of the transferred accounts receivable, and that, in any event, its application is barred by Section 351 of the Code, which provides that gain or loss shall not be recognized if property is transferred by a partnership (or sole

184 F. 2d 251, 254-255 (C.A. 3); *Edward Katzinger Co. v. Commissioner*, 44 B.T.A. 533, affirmed, 129 F. 2d 74 (C.A. 7); *Doylestown & Easton Motor Coach Co., v. Commissioner*, 9 T.C. 846, 850; *Bush Terminal Buildings Co. v. Commissioner*, 7 T.C. 793, 816-817; *Gould Coupler Co.*, 5 B.T.A. 499, 518.

proprietorship) to a controlled corporation. Petitioners would solve the double deduction problem either by requiring that the partnership's reserve be carried over to the corporate transferee, or by reducing the basis of the accounts receivable by the amount of the reserve.

We will show first that this is a proper case in which to apply the tax benefit rule because, when the partnership terminated, there was no longer any need for maintenance of the reserve. This, we submit, is a sufficient recovery to warrant application of the tax benefit rule. We will then show that application of the rule is in no way inconsistent with the proscription of Section 351 against recognition of gain or loss. With regard to petitioners' proposed solutions to the double deduction problem, we contend that neither solution is prescribed in the Code. In the absence of a Code directive requiring a carryover or a reduction in basis, the Commissioner's solution must be upheld, because it is reasonable and not inconsistent with the statute.

**THE COMMISSIONER PROPERLY APPLIED THE TAX BENEFIT RULE IN REQUIRING RESTORATION TO INCOME OF THE PARTNERSHIP'S BAD DEBT RESERVE UPON THE TRANSFER OF ITS ASSETS TO CONTROLLED CORPORATIONS**

**A. THE TAX BENEFIT RULE APPLIES WHEN A BAD DEBT RESERVE IS NO LONGER NEEDED, WHETHER OR NOT THERE HAS BEEN A CASH COLLECTION OF ACCOUNTS RECEIVABLE**

It is a fundamental principle of federal income taxation that a recovery of an item which has produced an income tax benefit in a prior year is to be added to income in the year of recovery. See, *e.g.*, *Alice Phelan*

*Sullivan Corp. v. United States*, 381 F. 2d 399, 401 (Ct. Cl.); *Merchants Nat. Bank v. Commissioner*, 199 F. 2d 657, 659 (C.A. 5); *Freihofer Baking Co. v. Commissioner*, 151 F. 2d 383, 386 (C.A. 3); *Union Trust Co. of Indianapolis v. Commissioner*, 111 F. 2d 60 (C.A. 7), certiorari denied, 311 U.S. 658; *Chicago, R.I. & P. Railway Co. v. Commissioner*, 47 F. 2d 990 (C.A. 7), certiorari denied, 284 U.S. 618; *Charleston & W. C. Ry. Co. v. Burnet*, 50 F. 2d 342 (C.A.D.C.). Although no provision of the Internal Revenue Code articulates the so-called tax benefit rule, it is engrained in the tax law and is recognized in Section 111, which prevents the restoration to income of "bad debts, prior taxes and delinquency amounts" to the extent that no tax benefit therefor has been allowed in a prior taxable year.<sup>7</sup> The rule rests on the notion that a taxpayer should not be permitted to retain the tax benefit of a deduction when later events demonstrate that he no longer is entitled to it. That the adjustment is made in a taxable year subsequent to the year in which the deduction is allowed is a consequence of the annual accounting system. See *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359.

Since a reserve for bad debts represents losses that are estimated will be sustained in subsequent taxable years, it is the accepted and longstanding general rule that any unabsorbed amounts in such a reserve must

<sup>7</sup> Section 111 would apply, for example, to prevent application of the tax benefit rule upon recovery of a bad debt allowed as a deduction in a prior year, where the loss did not result in a reduction of taxes because the taxpayer's other expenses completely offset his income.

be restored to income when the reserve is found to be excessive or no longer necessary—that is, when it becomes clear that the taxpayer will not suffer some or all of the estimated losses as a result of the uncollectibility of accounts receivable. *Arcadia Savings and Loan Assn. v. Commissioner*, 300 F. 2d 247 (C.A. 9); *West Seattle National Bank of Seattle v. Commissioner*, 288 F. 2d 47 (C.A. 9); *S. Rossin & Sons v. Commissioner*, 113 F. 2d 652, 654 (C.A. 2); *Citizens Federal S. & L. Ass'n of Cleveland v. United States*, 290 F. 2d 932, 936 (Ct. Cl.). See also *Handelman v. Commissioner*, 36 T.C. 560; *Geyer, Cornell & Newell, Inc. v. Commissioner*, 6 T.C. 96, 100; and *C. Standlee Martin, Inc. v. Riddell*, 56-2 U.S.T.C., par. 9989 (S.D. Calif.).<sup>\*</sup> These cases formed the basis for the Commissioner's ruling in 1962 that a reserve for bad debts must be restored to the income of a sole proprietorship or partnership upon the incorporation of its business, because, when the separate ownership of the business terminates, the taxpayer's need for a reserve also terminates. Rev. Rul. 62-128, 1962-2 Cum. Bull. 139.

In the first appellate decision to consider the question here presented, the Court of Appeals for the Ninth Circuit rejected the Commissioner's ruling. *Estate of Schmidt v. Commissioner*, 355 F. 2d 111. It did so despite its earlier recognition that it is a

<sup>\*</sup> Published rulings of the Commissioner have also applied this rule. For example, Rev. Rul. 57-482, 1957-2 Cum. Bull. 49, indicates that when a corporation sells its assets in a Section 337 liquidation (where gain or loss on the sale of property is not recognized), it realizes ordinary income to the extent of its reserve for bad debts.

"well established principle that additions to a reserve for bad debts previously deducted in computing taxable income must be included in taxable income when and to the extent that the reserve is no longer necessary." *Arcadia Savings and Loan Assn. v. Commissioner, supra*, p. 250. In *Arcadia*, the court had held that the tax benefit rule applied to require restoration of a bad debt reserve to income following a sale of substantially all of a corporation's assets, even though gain on the sale was not recognized under Section 337 of the Code.

The Ninth Circuit's rationale in *Schmidt*, upon which petitioners rely (Br. 31-34), was that although it was true that the taxpayer no longer needed the reserve, it was not true in an economic sense that he had "recovered" its value. 355 F. 2d at 113. As that court saw the matter, all that the taxpayer "recovered" in relation to the receivables transferred to the controlled corporation were stock certificates representing the net value (the face amount of the receivable less the reserve), rather than the face value, of the receivables. (*Ibid.*) Therefore, the court concluded that the tax benefit rule did not apply. It found *Arcadia* and the other prior decisions distinguishable on the ground that the value of the reserves in those cases had been recovered through actual sales of receivables. *Id.*, p. 113, n. 7.

Apart from the fact that the Ninth Circuit was mistaken in its reading of *Arcadia*—the amount of the reserve there was not actually collected\*—we submit

\* Nor can *Arcadia* be explained away, as the Ninth Circuit suggested (355 F. 2d at 113, n. 7), on the ground that it in-

that the court erred in holding that the tax benefit rule does not apply to a non-recognition transaction under Section 351, as well as to such a transaction arising under Section 337. To limit application of the rule to cases in which there has been an economic recovery would frustrate its purpose, which is to insure that a taxpayer not retain the benefit of a deduction to which it is no longer entitled. Fulfillment of that purpose requires application of the rule, whether the lack of need for a bad debt reserve arises from a sale or collection of accounts receivable, or merely by reason of the termination of the existence of the owner of the receivables.<sup>10</sup>

In addition to failing to take account of the purpose of the tax benefit rule, the Ninth Circuit rested its decision in *Schmidt* on three faulty premises.

First, the court stated (355 F. 2d at 113, n. 6): "Surely, if the taxpayer had sold the receivables, for involved "a change in accounting methods." There is no indication in the *Arcadia* opinion that such a change was the basis for the decision.

<sup>10</sup> The court of appeals' characterization of the income realized in *Schmidt* as "fictitious income, never received by the taxpayer in fact" (355 F. 2d at 114), does not change the fact that the taxpayer no longer needed the reserve that had been created. Nor does it justify the court's refusal to restore the reserve to income, since the bad debt deduction which gave rise to the reserve could be characterized, under the court's economic analysis, as "fictitious expense, never sustained by the taxpayer in fact." This Court recently has cautioned against the resolution of income tax problems on the basis of "economic" analysis which assumes as its premise that what is sought to be taxed is "fictitious" income. *Commissioner v. Gordon*, 391 U.S. 83, 90, n. 5. While that admonition was given in a different context, it is equally well taken here.

cash, for their net value, he would not have realized income in the amount of the reserve. Yet, just as surely, he would no longer 'need' the reserve." This observation, which the court presumably made to support its conclusion that the tax benefit rule may be invoked only where there is an economic recovery of a bad debt reserve, is, we submit, unfounded. When a taxpayer on the reserve method sells accounts receivable for their net value, he must nevertheless restore the reserve to income. Restoration is required because the loss he has sustained is not a bad debt loss, but rather a loss from the sale of property. *Levy v. Commissioner*, 46 B.T.A. 423, affirmed, 131 F. 2d 544 (C.A. 2), certiorari denied, 318 U.S. 780; *Benedum v. Granger*, 180 F. 2d 564 (C.A. 3); *Reed v. Commissioner*, 45 B.T.A. 1130, affirmed, 129 F. 2d 908 (C.A. 4); and *Von Hoffman Corp. v. Commissioner*, 253 F. 2d 828 (C.A. 8). The proper analysis of the transaction where accounts receivable are sold for their net value by a reserve method taxpayer is to restore the reserve to his income and accord him a loss on the sale of property.<sup>11</sup> That this loss (face value less amount realized) equals the amount of the restoration to income does not militate against the basic principle that the reserve must be restored to income when it is no longer needed, irrespective of whether there has been an economic recovery.

<sup>11</sup> The court of appeals' conclusion in *Schmidt* (355 F. 2d, at 114) that "where accounts receivable are sold for cash for less than face value, the difference being the amount of the reserve, the taxpayer does not then 'realize' a loss," seems obviously incorrect.

Second, there is no basis for the Ninth Circuit's assumption (355 F. 2d, at 113) that the tax benefit rule has no application where a taxpayer receives only "pieces of paper—stock certificates"—in exchange for the accounts receivable transferred. If a corporation liquidates and distributes its assets, including accounts receivable, to its shareholders in kind, the rule requires restoration of the reserve to the corporation's income, even though gain or loss is not recognized on the liquidation pursuant to Section 336 of the Code. This much petitioners concede (Br. 32) despite the fact that the corporation's "recovery" consists only of the stock certificates which are turned in by its shareholders.

Third, the court erred in refusing to consider the effect of its holding upon the corporate transferee in *Schmidt*. It stated (355 F. 2d at 114): "We do not pass upon the right of the corporation, at the commencement of its business, to set up the same reserve as an offset to the receivables entered upon its books. The only question before us is the liability of the individual taxpayer." This refusal, although couched in traditional terms of judicial restraint, cannot be squared with this Court's recent reaffirmance of the principle that "the Code should not be interpreted to allow \* \* \* 'the practical equivalent of double deduction,' \* \* \*, absent a clear declaration of intent by Congress." *United States v. Skelly Oil Co.*, 394 U.S. 678, 684. See pp. 5-6, *supra*. Whatever doubts may have existed as to the viability of this principle when *Schmidt* was decided in 1966 were resolved by *Skelly*

*Oil* in 1969. In approaching the question whether the tax benefit rule should have been applied in *Schmidt*, the court should have been mindful of the possibility that its decision could lead to the "practical equivalent of double deduction" \* \* \*."

There is, in sum, nothing in the Ninth Circuit's opinion that justifies its failure to invoke the tax benefit rule. Petitioners advance only one additional argument in support of that court's economic analysis. They rely (Br. 34) on Treasury Regulations, Section 1.111-1(a)(2), which provides: "Recoveries result from the receipt of amounts in respect of the previously deducted or credited section 111 items, such as from the collection or sale of a bad debt, refund or credit of taxes paid, or cancellation of taxes accrued. \* \* \*". Petitioners contend that because the Regulation includes examples of what the Ninth Circuit characterized as "economic" recoveries (355 F. 2d at 113), only such recoveries can come within the tax benefit rule. This is not correct. The use of the words "such as" in the Regulation makes it clear enough that what are referred to as examples of recoveries are only examples. Moreover, as we have noted (p. 13, *supra*), petitioners do not dispute that a recovery occurs when a corporation distributes its accounts receivable in liquidation, even though it receives only its shareholders' stock certificates in return. The recovery here is no different than that of a liquidating corporation and is sufficient to warrant application of the tax benefit rule.<sup>12</sup>

<sup>12</sup> Petitioners also contend (Br. 17) that the tax benefit rule does not apply here because "the taxpayer's need [for the bad

B. SECTION 351 OF THE CODE DOES NOT BAR APPLICATION OF THE  
TAX BENEFIT RULE

Section 351(a) of the Code provides that "[n]o gain or loss shall be recognized if property is transferred to a corporation \* \* \* by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control \* \* \* of the corporation. \* \* \*" The non-recognition rule of Section 351 is an exception to the general rule of Section 1002 that the entire amount of gain or loss (determined under Section 1001) resulting from the sale or exchange of property is to be recognized, with immediate tax consequences. If a transfer qualifies under Section 351, the basis of the property given up by the transferor becomes the basis of the stock received in the exchange. Section 358. Thus, the practical effect of Section 351 is to defer the recognition of gain or loss until the ultimate sale or disposition of the corporate stock by the transferor. See *Portland Oil Co. v. Commissioner*, 109 F. 2d 479, 488 (C.A. 1).

Petitioners' major contention is that the non-recognition rule of Section 351 precludes the application of the tax benefit rule in the circumstances of this case. Pointing to the legislative history of Section 351 (Br. 7-12), petitioners maintain that the policy of the pro-debt reserve] continues in a Section 351 transfer." This was not the rationale of the Ninth Circuit. That court agreed (355 F. 2d at 113) that the partnership's need terminated at the time of the transfer. In all events, petitioners' contention turns on the interpretation of Section 351 and whether the partnership's reserve may be carried over to the transferee corporations, matters with which we deal below, pp. 19-20, 26, n. 24, *infra*.

vision requires that the partnership's bad debt reserve not be restored to income, because a Section 351 transfer involves nothing more than a change in the form of ownership of an existing business.

The fallacy in petitioners' argument is that the language of Section 351 does not read as petitioners would have it read. It provides that "[n]o gain or loss shall be recognized if property is transferred to a corporation \* \* \* solely in exchange for stock or securities \* \* \*." But the Commissioner is not here seeking to tax "gain or loss." "Gain or loss" is a statutory term of art and can arise only "on the sale or exchange of property" as provided in Section 1002. A reserve for bad debts is not property, however. Nor is it capable of being sold or exchanged. "A reserve consists of entries upon books of account. It is neither an asset nor a liability. It has no existence except upon the books, and, unlike an asset or a liability, it can not be transferred to any other entity." *Geyer, Cornell & Newell, Inc. v. Commissioner*, 6 T.C. 96, 100. See also *J. E. Hawes Corp. v. Commissioner*, 44 T.C. 705, 707-708; *Bird Management, Inc. v. Commissioner*, 48 T.C. 586, 594-597; Finney and Miller, *Principles of Accounting, Intermediate* (4th ed. 1953), p. 534; Paton, *Advanced Accounting* (1947 ed.), p. 598. It follows—since a bad debt reserve is not "property" and cannot be transferred—that restoration of the reserve to income cannot result in "gain or loss." Thus, Rev. Rul. 62-128, 1962-2 Cum. Bull. 139, which requires restoration of the reserve when accounts receivable are transferred in a Section 351 transaction, does not contravene the restric-

tion of that provision against recognition of "gain or loss."<sup>13</sup>

Petitioners are in substance asking that the Court construe Section 351 as if it called for "non-recognition of gain, loss or income" (Br. 11), even though the statute provides only that "gain or loss" should not be recognized.<sup>14</sup> The legislative history upon which petitioners rely (Br. 7-12) to support their argument does not go beyond the language of the statute, however. That history shows only that Congress intended to insulate "gain or loss" from recognition in a Section 351 transfer. It is true that Congress could have legislated further and provided that income generally, not merely "gain or loss," should go unrecognized under Section 351, or that reserves should go over to the transferee of the assets, without immediate tax consequences. But Congress did not legislate further, and the courts should not extend the statute beyond its plain terms. As this Court has observed, "It is our judicial function to apply statutes on the basis of what Congress has written, not what Congress might have written." *United States v. Great Northern Railway Co.*, 343 U.S. 562, 575.

<sup>13</sup> Treasury Regulations, Section 1.453-9(c)(2), which provides that gain or loss shall not be recognized upon the transfer of installment obligations in a Section 351 transaction is not inconsistent with Rev. Rul. 62-128, *supra*, as petitioners contend (Br. 11-12). Unlike a reserve for bad debts, installment obligations are property and are capable of being transferred, and a taxpayer, therefore, can realize gain or loss on their disposition.

<sup>14</sup> In apparent contradiction, petitioners recognize (Br. 21) that "gain" as it appears in the term "gain or loss" is not coextensive with the concept of income.

None of petitioners' remaining arguments in support of their interpretation of Section 351 have merit. Their contention (Br. 17-18), that it would be "paradoxical" to restore the reserve to income in an otherwise tax-free transaction under Section 351, suggests that the reserve would not be so restored in a taxable transaction. As we have previously shown (pp. 11-12, *supra*), however, restoration of the reserve would be required in either event, for application of the tax benefit rule does not turn on whether a transaction is taxable, but simply on whether the need for the reserve has terminated. While petitioners are correct in pointing out that a taxable sale of receivables would result in no net income, that result obtains not because the tax benefit rule is inapplicable, but because the loss realized on the sale (the excess of the face amount of the receivables over ~~net~~ value) would offset the amount restored to income. When petitioners' partnership transferred its accounts receivable to the controlled corporations, petitioners realized a loss, just as they would have in a taxable transaction. Petitioners were barred from recognizing that loss, however, by the non-recognition rule of Section 351. There is thus nothing "paradoxical" in applying the tax benefit rule in an otherwise tax-free situation.

As the Fifth Circuit recognized below (R. 19), the paradox would arise if the rule were not applied, since petitioners would then in effect be recognizing the loss on transfer of the receivables which Section 351 says may not be recognized—along with any gains which

inherited in the overall transaction. In effect, petitioners are here seeking recognition of their losses, while their gains go unrecognized, which is not what Congress provided. Section 351 is equally applicable to gains and losses.

The contentions that a taxpayer's need for a bad debt reserve continues in a Section 351 transaction (Br. 17) and that application of Rev. Rul. 62-128, *supra*, would distort the income of both the transferor and the transferee in the transaction (Br. 18-19) assume the very point which is an issue. If, as we contend (pp. 16-17, *supra*), Congress did not legislate as broad a non-recognition rule as it might have when it enacted Section 351, the transferor and transferee cannot be considered the same taxpaying entity with respect to those items which do not constitute property or are not capable of being transferred—including a reserve for bad debts. This being the case, the "continuation of business" theory cannot apply with respect to such items. Absent this theory, there would be no continuing need for the reserve, because, for purposes of determining the adequacy of the reserve, the transferor would not be deemed a continuing entity.<sup>15</sup> There would likewise be no distortion of the income of either the transferor or the transferee, since the former's income would reflect all bad losses actually sustained up to the time of the transfer, and

<sup>15</sup> Once this is recognized, it becomes irrelevant—notwithstanding petitioners' contentions to the contrary (Br. 12, 17)—that the partnership's reserve, determined on the assumption that the partnership would continue to exist, was reasonable.

the latter's would reflect all such losses actually sustained thereafter.<sup>16</sup>

That the Commissioner first ruled on the question here presented in 1962 (Rev. Rul. 62-128, *supra*) does not warrant the inference drawn by petitioners (Br. 13, 26) that prior to 1962 he agreed with their proposed interpretation of Section 351. Nor can this inference be drawn from the fact that the question was first litigated in 1966 in *Estate of Schmidt v. Commissioner, supra*, as petitioners suggest (Br. 15). We are advised by the Internal Revenue Service that during the pre-ruling period the problem was handled on an *ad hoc* basis by revenue agents in the field. The ruling, which we believe to be completely consistent with Section 351, was designed to provide a uniform rule for all taxpayers and one which would, in all events, effectively prevent a double deduction. In these circumstances, there is no basis for interpreting the Commissioner's failure to rule before 1962 as indicative of his acquiescence in a rule contrary to that which we urge here.

C. THE EXISTING FRAMEWORK OF THE CODE IS NOT READILY ADAPT-  
ABLE TO EITHER OF PETITIONERS' PROPOSED SOLUTIONS TO THE  
DOUBLE DEDUCTION PROBLEM

Recognizing that a double deduction might result if the tax benefit rule does not apply (Br. 25, 29), petitioners argue that this problem can be avoided by requiring that a partnership's reserve for bad debts be carried over to a corporate transferee, or by recog-

<sup>16</sup> As noted above (p. 6, *supra*), the Commissioner would allow the transferee corporation to deduct bad debt losses on the receivables transferred to it.

nizing that the reserve reduces the basis for the receivables in the hands of the partnership. The first alternative would preclude a corporate transferee from claiming the same bad debt deduction allowed to the partnership, since the reserve in respect of the transferred receivables would be reflected on the corporation's books without the allowance of any additional deduction. The second alternative would accomplish the same purpose, since the corporate transferee would take the partnership's basis for the receivables pursuant to Section 362. While each proposed solution thus would prevent both parties to a Section 351 transfer from claiming the same deduction, neither solution is in line with prior judicial authority or with the technical requirements of the Code.

#### *1. Carryover of reserve for bad debts*

Section 381 of the Code is the basic statute dealing with the carryover of certain specified "items" (Section 381(a)) from one taxpayer to another. By its terms, it provides for carryovers only in cases involving intercorporate transfers of property—certain liquidations of corporate subsidiaries (Section 381(a)(1)) and certain corporate reorganizations described in Section 368 (Section 381(a)(2)).<sup>17</sup> It does not provide for the carryover of "items" in a transaction described in Section 351.

<sup>17</sup> These are the reorganizations described in Section 368(a)(1)(A), (C), (D) and (F). In the case of Section 368(a)(1)(D) reorganizations, the carryover rules are applicable only if the requirements of Section 354(b)(1)(A) and (B) are satisfied.

Among the items which are to be carried over by an acquiring corporation subject to Section 381 are the methods of accounting of the transferor corporation, including, where the transferor is using the reserve method of accounting for bad debts, its reserve for bad debts. See Section 381(c)(4); Treasury Regulations, Section 1.381(c)(4)-1(a)(1)(ii). Petitioners maintain that the rule of Section 381(c)(4) should apply here despite "the lack of specific statutory direction" (Br. 24).

To support this contention, petitioners again contend that the transfer from partnership to corporation constitutes nothing more than a mere change in the form of ownership of a business. They point out that this theory also underlies Section 361, which provides for nonrecognition of "gain or loss" upon the transfer of property from one corporation to another in a corporate reorganization, and conclude from this that bad debt reserves should be carried in corporate organizations as well as corporate reorganizations.

(1) Petitioners' conclusion ignores the well-settled rule that the transferee corporation in a Section 351 exchange is a new taxpayer and is entitled to adopt its own taxable year and its own accounting methods, including, in this instance, the specific charge off method for reporting bad debts.<sup>18</sup> See, *e.g.*, *Ezo*

<sup>18</sup> Petitioners argue to the contrary (Br. 25) in reliance on Treasury Regulations, Section 1.166-1(b)(1). While we do not agree that the Commissioner could prevent a corporate transferee from using the specific charge off method merely because the transferor used the reserve method, nothing in the cited

*Products Co. v. Commissioner*, 37 T.C. 385, 393-394; *Dearborn Gage Co. v. Commissioner*, 48 T.C. 190, 201, and cases cited therein. Indeed, the transferee is considered to be a new taxpayer with respect to depreciable assets received by it in the exchange and is therefore not entitled to use the accelerated methods of depreciation that are available only to original users of property under Sections 167 (b) and (c). Rev. Rul. 67-286, 1967-2 Cum. Bull. 101.

Finally, to the extent that Congress has permitted certain carryovers of tax attributes in Section 351 transactions, it has carefully delineated the carryovers. See Sections 47(b)(3), 1245(b)(3), and 1250(d)(3).<sup>19</sup> Except as to these specific provisions, Congress has apparently seen fit to limit the carryover of a bad debt reserve to certain types of corporate *reorganizations* and not the corporate *organization* encompassed in Section 351.<sup>20</sup> For the

Regulation empowers the Commissioner to insist on a carryover of the transferor's reserve in order to avoid a double deduction.

<sup>19</sup> Contrary to petitioners' contention (Br. 30), the enactment of these provisions is not indicative of any Congressional policy to treat Section 351 transfers and reorganizations in a "similar \* \* \* fashion." The legislative history of these specific enactments dealing with the investment credit and the recapture of depreciation reveals no such purpose. See H. Rep. No. 1447, 87th Cong., 2d Sess., pp. A15-A16, A109-A110; S. Rep. No. 1881, 87th Cong., 2d Sess., pp. 152, 282-283; H. Rep. No. 749, 88th Cong., 1st Sess., p. 105; S. Rep. No. 830, 88th Cong., 2d Sess., pp. 135-136.

<sup>20</sup> *Calavo, Inc. v. Commissioner*, 304 F. 2d 650 (C.A. 9), and *Home Savings and Loan Association v. United States*, 223 F. Supp. 134 (S.D. Calif.), relied upon by petitioners (Br. 22, n. 22), are not in point. Each of those cases involved transac-

only carryover aspect of Section 351, as set forth in that provision, is the requirement that the controlled corporation carry over the transferor's basis in the property transferred. Sections 351(d)(2) and 362, Appendix, *infra*, pp. 34-35.

Accordingly, whatever abstract merit a carryover of the bad debt reserve in the instant case might have, it is plain, at the very least, that Congress has not authorized such a carryover. Under these circumstances, the existing structure of the Code does not support the bad debt reserve carryover for which petitioners contend. As Judge Raum explained in *Schuster v. Commissioner*, 50 T.C. 98, 102, which approved the Commissioner's rule as applied in the instant case<sup>21</sup>—

The Code is a highly complex instrument, and it would be inappropriate, in order to reach a seemingly equitable result, to proceed upon theories that depart from an established course of decision or that do violence to the statute. In a field that is governed by so specific a statutory scheme relating to nonrecognizable transfers, any logical departure therefrom must be based on specific legislative modifications. The remedy is one that must be provided by Congress, rather than through a judicial reconstruction of a complex law. [Footnote omitted.]

tions—*Calavo*, a Section 332 liquidation, and *Home Savings*, a Section 368(a)(1)(A) reorganization—to which the carryover rules of Section 381 specifically apply.

<sup>21</sup> The Tax Court has adhered to its position in *Hutton v. Commissioner*, 53 T.C. 37.

This Court similarly observed in *Commissioner v. Gordon*,<sup>22</sup> 391 U.S. 83, 91-92, in construing another technical provision of Subchapter C, that "The requirements of the sections are detailed and specific, and must be applied with precision." Since the terms of the Code do not expressly require the carryover of a bad debt reserve from a partnership to a corporation, the Commissioner's rule requiring a restoration of the reserve to income is more closely in harmony with the Code's highly technical structure.<sup>23</sup>

(2) Given the existing framework of the Code, petitioners' contention that the Commissioner's rule yield to their carryover solution to the double deduction problem is unpersuasive. Not only do the highly articulated provisions of the Code point toward the correctness of the Commissioner's rule, but there is, in addition, no theoretical justification for broadly

<sup>22</sup> Petitioners rely (Br. 26-28) on the reasoning of the dissenting opinion in *Schuster* (50 T.C. at 103-104) to the effect that the legislative history of Section 381 indicates that it was not meant to be exclusive on the subject of carryovers of tax attributes. However, it should be noted that the Committee Report references deal only with carryovers from predecessor to successor corporations and do not expressly refer to carryovers from partnerships to corporations in a Section 351 exchange. While petitioners are correct (Br. 27) in observing that prior to the enactment of Section 381, the courts, in certain instances, permitted carryovers, those cases all involved intercorporate transfers. Furthermore, the results were by no means uniform. Compare, *Libson Shops, Inc. v. Koehler*, 353 U.S. 382, with *Helvering v. Metro. Edison Co.*, 306 U.S. 522. Significantly, petitioners do not advance any cogent argument for returning to the era of court-made law in this highly technical area, given the precise and detailed manner in which Congress has established the ground rules in Section 381.

analogizing a Section 351 transfer to a corporate reorganization.

All of the corporate reorganizations to which the carryover provisions of Section 381 apply involve business amalgamations accomplished either by statutory merger or consolidation (Section 368(a)(1)(A)) or by a transfer of substantially all of the assets of the transferor corporation (Section 368(a)(1)(C), (D), and (F)).<sup>23</sup> This is likewise true of the corporate liquidations to which the Section 381 rules apply. The carryover rules can apply only in the case of complete liquidations of subsidiaries under Section 332. A Section 351 transaction, on the other hand, may involve the transfer of a single asset. It is thus entirely reasonable for Congress not to have carried the continuation of business theory as far in the corporate organization area as it did in the area of corporate reorganizations.<sup>24</sup>

<sup>23</sup> The Section 368(a)(1)(C) reorganization requires a transfer of "substantially all of the properties" of the transferor. Similarly, the non-divisive Section 368(a)(1)(D) reorganization, by operation of Section 354(b)(1)(A), requires a transfer of "substantially all of the assets" of the transferor. And, the Section 368(a)(1)(F) reorganization—"a mere change in identity, form, or place of organization \* \* \*"—presupposes the transfer of an entire business organization.

<sup>24</sup> Petitioners ask rhetorically (Br. 20) how the need for a bad debt reserve can terminate in a Section 351 transaction, so as to justify invocation of the tax benefit rule, while the need would not terminate in an otherwise comparable corporate reorganization situation. The answer to this question is that in enacting Section 381, Congress determined that the need continues in the latter situation. Its failure to include Section 351 transactions within the coverage of Section 381 indicates that it made no such determination with respect to corporate organizations.

Further reason for the Congressional decision may be found in the fact that although corporate reorganizations, by definition, involve only corporations, a Section 351 transfer may involve a non-corporate party. The distinction between individual and corporate taxpayers is manifest throughout the Code. First, graduated tax rates are imposed upon individuals by Section 1, while corporations are subject to the normal tax and surtax under Section 11.<sup>25</sup> In addition, the assumption of corporate form triggers an entire body of detailed provisions (Sections 301-318, 332-337, 354-382) and presents a variety of benefits and elective options (*e.g.*, Sections 243-246, 421-425 and 1371-1378) and potential liabilities (Sections 341, 531-537, 541-547), none of which apply to non-corporate taxpayers. All of this suggests that it would be inappropriate to draw a broad analogy between the corporate organization and reorganization provisions of the Code.<sup>26</sup>

(3) Moreover, although a carryover of a bad debt reserve would prevent the deduction of the same bad

<sup>25</sup> The Fifth Circuit regarded this difference in tax rates as significant (R. 19) in upholding the Commissioner's rule requiring restoration of the bad debt reserve to income.

<sup>26</sup> It would likewise be inappropriate to draw such a broad analogy on the basis of this Court's decision in *Helvering v. Cement Investors, Inc.*, 316 U.S. 527. The Court there noted (p. 534) the "close relationship" between the organization and reorganization provisions, in holding that the former, rather than the latter, were applicable in the circumstances presented. But the Court also recognized the distinction we have discussed above. It observed (p. 533) that "[w]hile the 'reorganization' provisions are restricted to inter-corporate transactions § [351] is not so confined \* \* \*."

debt loss by the transferor and transferee in a Section 351 transaction, it would result in a double benefit for the transferor. This double benefit arises by reason of the operation of Section 358. Under that provision, the transferor in a Section 351 transaction receives a tax basis in the corporate stock he acquires equal to the basis of the property he transfers, here the face amount of the accounts receivable.<sup>27</sup> On the other hand, the value of the stock he receives would be equal to the net value of the receivables (face amount less reserve). Accordingly, the tax benefit which resulted when the reserve was established is perpetuated in an inflated basis for the corporate stock received. Unless the reserve is taken into income at the time of the Section 351 transfer, the transferor could ultimately diminish his income twice: once when he established the reserve and obtained a bad debt deduction, and a second time when he disposes of the stock and is permitted to use its inflated basis in computing gain or loss.

## *2. Reduction in basis of accounts receivable*

Presumably in recognition of the fact that their reserve carryover proposal solves one double deduction problem but creates another, petitioners contend (Br. 30-31) that the basis of accounts receivable in the hands of a taxpayer on the reserve method should be reduced at the time the taxpayer takes a deduction that increases the reserve, rather than at the later

<sup>27</sup> As we explain below (pp. 29-30, *infra*), there is no statutory authority whereby the basis of the receivables transferred can be adjusted downward to reflect the bad debt reserve.

time when the reserve is decreased to reflect the worthlessness of a specific account. But the Code no more provides for a basis reduction prior to the actual worthlessness of an account than it does for a carryover.

Under Section 1016(a)(1), adjustments to basis may be made "for expenditures, receipts, losses, or other items, properly chargeable to capital account \* \* \*." The deduction that increases the reserve does not come within any of the specified categories. It cannot be considered a loss because, at any given time, the reserve reflects only losses which it is estimated will be sustained in the future. Nor can it be considered an "other item" chargeable to capital account, since it reflects a provisional estimate rather than a fixed and final determination and, as a matter of accounting technique, is not chargeable against accounts receivable.<sup>28</sup> See *Accountants' Handbook* (4th ed. 1957), Sec. 11.24; Karrenbrock and Simons, *Intermediate Accounting* (2d ed. 1953), pp. 87, 184.

<sup>28</sup> Petitioners point out that a taxpayer on the specific charge off method may reduce his basis in accounts receivable at the time he becomes entitled to a bad debt deduction—when a specific account becomes worthless. They maintain that a reserve method taxpayer should be entitled to reduce basis at the time he becomes entitled to a bad debt deduction—when he increases the reserve in advance of actual worthlessness—and that not to allow a basis reduction at that time is discriminatory. This argument ignores the language of Section 1016(a)(1) and the rationale of the reserve method itself. There is no discrimination between specific charge off and reserve method taxpayers. Both are entitled to a basis adjustment when a loss is in fact sustained.

Finally, we deal with the argument that a reserve for bad debts should be treated as reducing basis on the theory that it is like a reserve for depreciation which does reduce basis. The reduction in basis for a depreciation reserve is not made under Section 1016 (a) (1), however, but is specifically provided for in Section 1016(a) (2). See also *West Seattle National Bank of Seattle v. Commissioner*, 288 F. 2d 47, 49 (C.A. 9); *National Bank of Commerce of Seattle v. Commissioner*, 115 F. 2d 875, 877-878 (C.A. 9). No comparable specific provision prescribes a basis adjustment for a bad debt reserve.

D. SINCE THE COMMISSIONER'S SOLUTION TO THE DOUBLE DEDUCTION PROBLEM IS REASONABLE, IT MUST BE UPHELD EVEN IF HE MIGHT HAVE SOLVED THE PROBLEM BY OTHER MEANS

Under Section 7805(a) of the Code, the Commissioner is empowered to "prescribe all needful rules and regulations for the enforcement of this title \* \* \*." The Commissioner exercised the discretion confided to him thereunder in Rev. Rul. 62-128, *supra*. There he prescribed a uniform rule for all taxpayers and one which would insure against the possibility of a double deduction for the same bad debt loss.

As we have shown, the Commissioner's rule requiring restoration of the reserve to income in the circumstances of this case is fully consistent with all pertinent statutory provisions. That, we submit, should be the end of the matter. For even if the Commissioner could properly have resolved the double deduction problem by other means, it was not error for him not to have done so. Petitioners maintain that the

Commissioner could have required a reserve carry-over or a reduction in basis of accounts receivable under Sections 351, 381 and 1016. In addition, petitioners suggest (Br. 29) that the Commissioner might have acted under Section 446 (relating to methods of accounting) or Section 482 (relating to allocation of income and deductions among taxpayers). Whatever the merits of these alternative solutions, the Commissioner has chosen to restore the reserve to income—a result firmly grounded upon the well-settled tax benefit rule. Under these circumstances, it is of no significance that there may be alternative methods to deal with the problem. As this Court observed in *United States v. Correll*, 389 U.S. 299, 306–307—

Alternatives to the Commissioner's \* \* \* rule are of course available. Improvements might be imagined. But we do not sit as a committee of revision to perfect the administration of the tax laws. Congress has delegated to the Commissioner, not to the courts, the task of prescribing “all needful rules and regulations for the enforcement” of the Internal Revenue Code. 26 U.S.C. § 7805(a). \* \* \*

## CONCLUSION

For the reasons stated, it is respectfully submitted that the judgments of the court of appeals should be affirmed.

ERWIN N. GRISWOLD,  
*Solicitor General.*

JOHNNIE M. WALTERS,  
*Assistant Attorney General.*

MATTHEW J. ZINN,  
*Assistant to the Solicitor General.*

GILBERT E. ANDREWS,  
STUART A. SMITH,  
*Attorneys.*

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## APPENDIX

### Internal Revenue Code of 1954 (26 U.S.C.):

#### SEC. 166. BAD DEBTS.

##### (a) *General Rule.*—

(1) *Wholly worthless debts.*—There shall be allowed as a deduction any debt which becomes worthless within the taxable year.

(2) *Partially worthless debts.*—When satisfied that a debt is recoverable only in part, the Secretary or his delegate may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction.

(b) *Amount of Deduction.*—For purposes of subsection (a), the basis for determining the amount of the deduction for any bad debt shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

(c) *Reserve for Bad Debts.*—In lieu of any deduction under subsection (a), there shall be allowed (in the discretion of the Secretary or his delegate) a deduction for a reasonable addition to a reserve for bad debts.

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#### SEC. 351. TRANSFER TO CORPORATION CONTROLLED BY TRANSFEROR.

(a) *General Rule.*—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation. For purposes of this section, stock or securities issued for services shall not be considered as issued in return for property.

(b) *Receipt of Property.*—If subsection (a) would apply to an exchange but for the fact that there is received, in addition to the stock or securities permitted to be received under subsection (a), other property or money, then—

(1) gain (if any) to such recipient shall be recognized, but not in excess of—

(A) the amount of money received, plus

(B) the fair market value of such other property received; and

(2) no loss to such recipient shall be recognized.

(c) *Special Rule.*—In determining control, for purposes of this section, the fact that any corporate transferor distributes part or all of the stock which it receives in the exchange to its shareholders shall not be taken into account.

(d) *Cross References.*—

(1) For special rule where another party to the exchange assumes a liability, or acquires property subject to a liability, see section 357.

(2) For the basis of stock, securities, or property received in an exchange to which this section applies, see sections 358 and 362.

(3) For special rule in the case of an exchange described in this section but which results in a gift, see section 2501 and following.

(4) For special rule in the case of an exchange described in this section but which has the effect of the payment of compensation by the corporation or by a transferor, see section 61(a)(1).

#### SEC. 362. BASIS TO CORPORATIONS.

(a) *Property Acquired by Issuance of Stock or as Paid-In Surplus.*—If property was acquired on or after June 22, 1954, by a corporation—

(1) in connection with a transaction to which section 351 (relating to transfer of property to corporation controlled by transferor) applies, or

(2) as paid-in surplus or as a contribution to capital,

then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer.

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**Treasury Regulations on Income Tax (1954 Code)**  
**(26 C.F.R.):**

**SEC. 1.166-4. RESERVE FOR BAD DEBTS.**

(a) *Allowance of deduction.*—A taxpayer who has established the reserve method of treating bad debts and has maintained proper reserve accounts for bad debts or who, in accordance with paragraph (b) of § 1.166-1, adopts the reserve method of treating bad debts may deduct from gross income a reasonable addition to a reserve for bad debts in lieu of deducting specific bad debt items.

(b) *Reasonableness of addition to reserve—*

(1) *Relevant factors.*—What constitutes a reasonable addition to a reserve for bad debts shall be determined in the light of the facts existing at the close of the taxable year of the proposed addition. The reasonableness of the addition will vary as between classes of business and with conditions of business prosperity. It will depend primarily upon the total amount of debts outstanding as of the close of the taxable year, including those arising currently as well as those arising in prior taxable years, and the total amount of the existing reserve.

(2) *Correction of errors in prior estimates.*—

In the event that subsequent realizations upon outstanding debts prove to be more or less than estimated at the time of the creation of the existing reserve, the amount of the excess or inadequacy in the existing reserve shall be reflected in the determination of the reasonable addition necessary in the current taxable year.

(c) *Statement required.*—A taxpayer using the reserve method shall file with his return a statement showing—

(1) The volume of his charge sales or other business transactions for the taxable year and the percentage of the reserve to such amount;

(2) The total amount of notes and accounts receivable at the beginning and close of the taxable year;

(3) The amount of the debts which have become wholly or partially worthless and have been charged against the reserve account; and

(4) The computation of the addition to the reserve for bad debts.

(d) *Special rules applicable to certain banking organizations.*—For special rules for the addition to the bad debt reserves of certain mutual savings banks, domestic building and loan associations, and cooperative banks, see §§ 1.593-1 through 1.593-11.

